Policy Analysis

CATO INSTITUTE

Center for Monetary and Financial Alternatives

May 3, 2016 | Number 790

A Walk Through the JOBS Act of 2012

Deregulation in the Wake of Financial Crisis

By Thaya Brook Knight

EXECUTIVE SUMMARY

In 2011, on the heels of the financial crisis and after passing the behemoth known as the Dodd-Frank Act, Congress did something unexpected: it passed, with wide bipartisan support, a piece of legislation that rolls back regulation of the financial sector. In early 2012 President Obama signed it into law. The legislation, the Jumpstart Our Business Startups Act, or JOBS Act of 2012, aims to help small businesses access capital by lowering barriers in several areas of the securities laws.

Traditionally, small businesses have relied on personal savings, help from family and friends, and small banks for cash infusions. However, the community banks that have typically provided the bulk of small business loans have been disappearing. Moreover, the fact that the recent crisis originated in the housing market put additional pressure on small business lending since many small businesses use the owner's home to secure the loan.

While larger businesses have always turned to the capital markets to raise funds, these markets are more difficult for smaller companies to access. Regulation has always been a high barrier to entry, and, until recently, smaller companies have had no means of reaching a large audience of potential investors as publicly owned companies do. The advent of the Internet has, however, removed this second obstacle, and vehicles such as crowdfunding seem tailor-made to meet small businesses' funding needs. The remaining great barrier was therefore regulation. The JOBS Act takes aim at key regulatory hurdles in several sections of the securities laws, seeking to lower the thresholds to make securities offerings a feasible option for a range of small business models.

Although the JOBS Act has taken important strides toward beneficial deregulation, more work remains to be done. The act's crowdfunding provision is laden with protections that are likely to make it unworkable. Moreover, the regulations implementing the provision have rendered it even more cumbersome. Other titles suffer from similarly poor implementation. Even though some aspects of the act and its regulations could be improved, the mere existence of deregulatory legislation aimed at small business and financial innovation is encouraging and can serve as a template for other deregulatory attempts going forward.

Thaya Brook Knight is associate director of financial regulation studies at the Cato Institute. She is an attorney with extensive experience in securities regulation, small business capital access, and capital markets.

“Small companies have faced a double whammy when looking for capital: the contraction of bank lending and the increase of regulation in the securities markets.”

INTRODUCTION

Small businesses have been called the backbone of our economy,[1] the nation's job-creation engine,[2] and the ultimate expression of American individualism and entrepreneurial spirit.[3] They comprise a wide array of business models, providing a myriad of goods and services, making them fertile ground for innovation. Indeed, small businesses are vital to our country's growth and prosperity. The vast majority of American companies are small businesses, including 99.7 percent of U.S. employer firms.[4] They produce roughly half of the country's GDP, and the majority of Americans work for small businesses. Clearly, any plan to improve our long, slow climb out of the economic doldrums that have followed the Great Recession must include nurturing small business development.

This development requires capital. Traditionally, small businesses have relied on owners' personal savings, personal credit cards, and bank loans. Unfortunately, the community banks, which have been the biggest providers of small business loans, are disappearing. The total number of community banks has fallen from more than 14,000 in the mid-1980s to fewer than 7,000 today.[5] Since 1994, the share of U.S. banking assets held by community banks has decreased by more than a half, falling from about 41 percent to 18 percent.[6] Many have been swallowed by bigger banks, while others failed in the Great Recession. The remaining small banks, responding to both new regulation, including the Dodd-Frank Act, and ongoing regulatory uncertainty in the banking sector, have tightened standards and conserved capital. The large banks, meanwhile, have been quietly shuttering their small business lending programs, finding them to be unprofitable. Both the decline in community banking and the increased hesitancy among major banks to lend to small businesses may have contributed to the decline in small business loans from 50 percent of all bank loans in 1995 to only 30 percent in 2013.[7]

The other major source of capital is the sale of securities. A company may choose to “go public” and sell its securities (typically stock) in the public capital markets following a registration of the offering with the Securities and Exchange Commission (SEC). A company may also choose to forgo the expense and hassle of a public offering and instead opt for a private placement or other sale that relies on provisions in the securities laws exempting certain sales from full registration requirements.

While selling securities can be a very attractive option, and is almost always necessary for companies that grow to a certain size, it has considerable drawbacks.[8] The laws governing the issuance, sale, and resale of securities are notoriously complex and can trigger significant liability, including criminal liability, if handled improperly. Large companies are subject to virtually the same laws and same liability as small companies, but because much of the compliance cost is fixed, the cost as a percentage of the total capital raised through any given offering of securities is higher for smaller issuers. Additionally, the trend in recent years has been to increase the regulatory burden on many types of securities offerings.

Small companies have therefore faced a double whammy when looking for capital: the contraction of bank lending to small businesses and the increase of regulation in the securities markets. In addition, while the traditional sources for capital have remained stagnant, the diversity of business models that make up the universe of small businesses has expanded rapidly since the advent of the Internet. Bank lending, with its need for hefty documentation, may simply be inappropriate for some types of newer start-up enterprises. Small businesses need other options.

In 2012, Congress passed the Jumpstart Our Business Startups Act (JOBS Act) designed specifically to address the capital needs of small companies. This legislation includes a number of provisions, ranging from a phased-in initial public offering (IPO) process to a new crowdfunding exemption. The JOBS Act is unusual in that, in each of its titles, it *pares back* regulation, allowing companies additional freedom in pursuing capital. Neither the JOBS Act itself

nor its implementing regulation is ideal, but it provides an excellent model for how to identify and repeal purported "protections" that are effectively protecting the economy from growing. It is also a tentative step toward addressing the need for diversity in funding options that reflects the diversity in small business itself.

What is Small Business?

What constitutes a small business is often difficult to define, although several organizations have tried. The federal Small Business Administration has more than 70 categories of small businesses, with specific qualifications based on revenues and number of employees.[9] The Small Business Act of 1953, on the other hand, defined small business more qualitatively, as an entity that is independently owned and operated and is not dominant in its field of operation.[10] The Internal Revenue Service takes a more quantitative approach, defining small business as partnerships and corporations with assets of $5 million or less, or any sole proprietorship.[11] A commonly cited definition is any firm with fewer than 500 employees.[12] The mechanic down the street whose business has been passed down through three generations, the law firm with five lawyers, the mom who makes jewelry in her basement to sell online, the three college friends building an app in a garage, and the manufacturing plant with a hundred employees are all small businesses. These businesses differ in size, capitalization, structure, and lifecycle. This heterogeneity complicates the discussion of small-business capital access because the needs of small businesses are not uniform, nor is the suitability of different types of capital.

Whether a certain type of capital will be appropriate for a company will depend on factors such as how the company plans to use the capital, what the company's anticipated growth trajectory looks like, how the company is structured, and other factors that are only loosely related to the company's annual revenues or number of employees. One important distinction is between established companies and start-ups.

An established company may need capital to manage cash flow, invest in advertising or new hires, or to expand. But, while the company may grow to some extent, it is unlikely to have exponential growth or to grow beyond the small business classification. The established company will typically have a considerable amount of financial documentation, including bank statements, a credit history, and several years of revenue. In addition, owners and management at established companies generally have several years of experience in the field, and often many years of experience running this particular business in this particular location.

Start-ups, on the other hand, have very little to show beyond an idea, the skills and experience the management brings from other ventures, and possibly a limited proof-of-concept or a small revenue stream. While the start-up's founders may have quite sophisticated expertise in certain areas, the team may lack the kind of operational and management experience necessary to launch a successful venture. This may be especially true of the start-up with large, public-company aspirations. Also, while an established company may need modest amounts of capital on a periodic basis if it is using the capital to manage cash flow, a start-up typically needs large injections of cash at a few major inflection points that mark the company's biggest growth spurts.

Given the diversity of business models used by small firms, adequate access to small business capital relies on a nimble marketplace that can leverage new technology and innovative solutions. This will be a marketplace that greets such innovation warmly, and not one that stifles it under an antiquated regulatory regime.

Sources of Small Business Capital

To understand the current strictures on small business capital access it is necessary first to understand where small businesses have traditionally obtained capital. Small business capital options exist on a continuum from the easily accessible and easily controlled, but

"Adequate access to small business capital relies on a nimble marketplace that can leverage new technology and innovative solutions."

> "Offerings of securities in the United States are governed at the federal level by the Securities Act of 1933."

also typically very limited, personal assets of the owner or retained company earnings, to the difficult to access and control, but exponentially larger assets of the capital markets.

On the personal side, the owner may use savings and credit cards, possibly pooling these with co-owners to amass seed money.[13] (According to a National Small Business Association survey, 36 percent of small businesses used personal credit cards; 18 percent received a loan from friends and/or family in 2014.[14]) If these fall short, the owners may ask friends and family for informal loans or investments. These types of investments can prove tricky for many new business owners. Founders unfamiliar with securities law may not realize that asking a relative to invest in a company is the sale of securities, typically of something akin to common stock, and therefore puts the founders and the company at risk of violating federal and state securities law. These investments, while not fatal to the company, often create stumbling blocks later on as the company grows. Future investors will likely insist that these improperly made investments be unwound, requiring rescission offers to the founder's mom and dad, rich aunt, and other family and friends who helped get the company off the ground.

Bank lending is also common among small businesses. Loans may be provided by banks of any size, but small banks provide a larger proportion of loans under $1 million and under $100,000. In 2011, banks with assets of $250 million or less accounted for 4 percent of total U.S. banking assets, but made 13.7 percent of business loans for less than $1 million and 13.9 percent of all loans for less than $100,000.[15] The 2014 National Small Business Association report showed that 20 percent of small businesses received a loan from a community bank in 2014, while 17 percent had received a loan from a large bank.[16] The process of securing a loan can be time-consuming for the small business owner. It typically requires the owner to complete an application and to provide information including personal history (credit history, criminal record, business experience), personal financial and bank statements, the business's credit history, business licenses, tax returns, a business plan, legal documents such as articles of incorporation and key contracts, as well as additional materials that may be required by individual institutions.

Additionally, in many cases a small business will be required to post collateral of some kind to secure the loan. If the company owns assets, such as equipment or real estate, these may be sufficient. If the company does not own assets sufficient to secure the loan, the business owner may post personal assets, including real estate such as a family home. The federal Small Business Administration also operates programs that provide guarantees to assist small businesses in obtaining loans for which they might not otherwise qualify.[17]

Once the application has been submitted it may take the bank several months to make a decision on whether to issue the loan. If the application is rejected, the company will have to start the application process anew with another bank.[18] It has been estimated that the process of applying for a small business loan can take as much as 20 hours of work on the part of the business.[19] The long delay in waiting for a decision, plus the prospect of applying to another bank and waiting on that bank's decision, can make bank lending unattractive for rapidly growing companies. Additionally, because of the hefty documentation required by banks, a bank loan is generally a better fit for an established company looking to grow than for a start-up looking for seed money.

If a company is unable to access sufficient capital by drawing on the owner's personal assets and is unable or unwilling to take out the types of loans described above, the company will look for outside investment. Offerings of securities in the United States are governed at the federal level by the Securities Act of 1933 ("the Securities Act"). In general, a company issuing securities must register the offering with the SEC or the offering must qualify for an exemption. Full registration with the SEC allows a company to sell its securities to the

general public and allows buyers of these securities to sell them freely in the secondary market. Because registration with the SEC can be extremely costly due to the number and complexity of the required disclosures, a company that goes public has typically grown to such a size that it needs to sell its securities in the public markets to raise sufficient capital to ensure its continued growth.

Once a company makes an initial public offering it becomes subject to a further regulatory regime requiring periodic financial disclosures—for example, the annual report or Form 10-K, and the quarterly Form 10-Q—as well as disclosures of certain major company events on an ongoing basis. It must also disclose sensitive information about the company's business model and operations—information that can be very useful to competitors.

As with most regulatory regimes, failure to comply carries a range of possible penalties, opening the company and its officers, directors, and hired experts to varying degrees of liability, criminal and civil, both to the government and to individual plaintiffs. Given the cost, regulatory burden, and potential liability, a company will typically pursue an IPO only when it is seeking a very large raise—usually in the eight- or nine-figure range.

But a public offering is not the only way to obtain investment. The basic principle underlying the regulation of securities in the United States is this: any offer or sale of securities to the public must be registered with the appropriate state and federal regulators or qualify for an exemption. While the public offering—one duly registered with the proper authorities—is perhaps the best-known to those outside the securities world, there are several exemptions that permit the issuance of securities with only limited disclosures to the SEC and investors. Each exemption includes its own set of rules and its own set of pros and cons. Many of these are specifically aimed at providing access to capital for issuers who find an IPO to be a poor fit. The JOBS Act includes a number of changes that specifically target exemptions attractive to small businesses with the goal of making these exemptions more effective and more user-friendly.

Effect of the 2008 Financial Crisis on Small Business Capital Access

As we have seen, small businesses tend to turn to small banks when seeking loans. The average small business loan is a few hundred thousand dollars,[20] and more than half of small business loans in 2012 were issued by banks with less than $10 billion in assets.[21] Small banks were in decline even before the financial crisis, but the crisis accelerated their demise. Of the 325 banks that failed during the crisis, 263, or 81 percent, were community banks, typically defined as banks with assets under $1 billion.[22] Surviving banks tightened lending, both in response to economic uncertainty and to pressure from regulators to maintain higher capital levels and impose more stringent lending standards. The remaining community banks have seen their share of small business lending shrink 21 percent since 2000.[23]

While some small banks have simply closed, many were absorbed by larger banks. According to a Federal Reserve Bank of Kansas City report, 90 percent of the 1,500 bank mergers since 2007 involved a bank with less than $1 billion in assets.[24] Although a large bank may keep its small bank acquisitions open as branch offices, large banks' business models are often not compatible with the realities of small business lending. In particular, large banks, those with more than $10 billion in assets, tend to be formulaic in their approach to lending, using credit scores such as PAYDEX or FICO and financial statements to make their determinations. In a large, widely dispersed organization, such quantifiable methods of decisionmaking are essential to ensure management can evaluate performance and maintain control across branches. Community banks, however, are more likely to have formed relationships with their business clients. They are also likely to be attuned to the community's economic health, and therefore can assess whether a loan applicant with a low credit score or unattractive financial statements may nonetheless be a good credit risk.

"Any offer or sale of securities to the public must be registered with the appropriate state and federal regulators or qualify for an exemption."

> "What is remarkable about the JOBs Act is that each provision actually reduces some part of the regulatory burden."

And then there were the effects of the housing market. Although the focus during and after the crisis has been on foreclosures and mortgage delinquencies, plummeting home values were also devastating to small business lending. As property values fell so did the value of loans that could be secured by home equity, as well as the number of houses that could support a second mortgage.

Through the end of the recession and into the early 2010s, options for small business capital looked very much the same as they had for the past 75 years. Funding options included personal savings and credit cards, loans often secured by the family home, and access to the capital markets through channels largely unchanged since the federal securities laws were written in the early 1930s. But even these options were narrower than they had been in earlier years. Credit had tightened in the crisis. Home values were down and small banks were disappearing. Going public had become increasingly unattractive to small companies, given the increase in regulatory compliance cost. There were, however, innovations underway in other sectors that would eventually make their way into the small business capital market.

The Jumpstart Our Business Start-Ups Act of 2012

In response to tightening credit markets, especially in the small business sector, Congress passed the Jumpstart Our Business Start-ups Act in late 2011; the act was then signed into law by President Obama in early 2012. The act is a mishmash of provisions aimed at helping smaller companies. What is remarkable about it is that each provision actually *reduces* some part of the regulatory burden. Given the overall trend toward increasing regulation in the financial sector, and the acceleration of this trend coming out of the Great Recession, it is stunning that this act was passed at all—and more stunning still that it passed with overwhelming bipartisan support.[25]

The act incorporates several concepts already emerging at the time, including most notably a new crowdfunding exemption under the federal securities laws. Other key provisions, described in detail below, include a modified IPO process for smaller companies, changes to the private placement exemption, changes to reinvigorate the exemption under Regulation A, and a provision that expands the number of shareholders a company may have before it is required to register as a public company. The provisions are only loosely related to one another, but they all relax securities regulation in ways intended to benefit small businesses.

This diversity in approaches may be the act's greatest strength. As discussed above, there is no dominant model when it comes to small businesses; the category includes firms using a wide array of models and organizational structures. The provision of adequate capital for such varied business models will require a broad range of capital solutions. Each of these provisions offers something different, and valuable, to smaller businesses.

To fully understand how the act assists in capital formation, it is useful to review each of the provisions individually. The next several sections of this paper will walk through each provision in turn, examining how various exemptions worked prior to the JOBS Act's passage, what changes the act made, and how these are likely to play out. Each section concludes with a number of policy recommendations aimed at making the changes initiated by the JOBS Act more effective and removing unnecessary barriers to small business growth.

TITLE I: THE IPO ON-RAMP

Title I of the act creates a modified IPO process, nicknamed the "IPO on-ramp" because it offers companies the option of scaling up their disclosure and compliance process gradually. This provision grew out of concern that companies, especially smaller and younger companies, were delaying IPOs or forgoing them altogether due to increased regulatory complexity and risk. The on-ramp is designed to make the process of going public easier for

those companies that are otherwise ready for the public markets but that may be shy of taking the plunge.

This provision creates a new "emerging growth company" (EGC) designation that applies to companies with less than $1 billion in annual gross revenues and provides up to five years of forbearance from certain reporting requirements leading up to, during, and immediately after the company's IPO. [26] Among the key features of the title are the ability to pitch the IPO to institutional investors before filing papers with the SEC (a process known as "testing the waters"); to initiate the IPO process confidentially; and to opt out of certain Sarbanes-Oxley and Dodd-Frank provisions related to accounting disclosures and executive pay disclosures, respectively. The provision also permits research analysts employed by the underwriter to publish research reports immediately upon the earnings release, instead of requiring the analysts to wait a specified number of days.

Given the $1 billion cap, the EGC designation applies to a number of companies that few would consider to be "small" businesses. In fact, companies qualifying as EGCs include the vast majority—80 percent—of companies that have gone public since the on-ramp went into effect in 2012. The on-ramp may therefore best be understood as a measure to increase the attractiveness of IPOs in general, although several of its provisions are especially appealing to smaller companies.

The IPO on-ramp, unlike other provisions in the JOBS Act, required no implementing rules before becoming effective. Although it has been only three years since the act was passed, there are indications that it has succeeded in its goal of increasing the number of IPOs, with the greatest increase among smaller firms and especially among biotechnology firms. Because the equities market has been so bullish in the years since the JOBS Act was passed, it is difficult to say with certainty how much of an effect the act had independent of market forces. However, some evidence supports the conclusion that, controlling for market conditions, the IPO on-ramp accounts for an increase of 21 IPOs, or 25 percent, over pre–JOBS Act levels.[27]

The on-ramp's appeal was intended, in part, to derive from the ability to pursue a more streamlined disclosure process.[28] The average cost of an IPO has been estimated at about $3 million, with the bulk of this expense going to the lawyers and accountants who prepare the filing documents .[29] Whether the offering is for $10 million or $100 million, the work required to prepare these materials remains relatively fixed. The ability to opt out of some legal disclosures was intended to reduce the compliance cost and therefore render those costs a smaller percentage of the overall IPO cost.

Ultimately, however, the reduced disclosure has not been the provision's most attractive feature. Despite the fact that EGCs can, for example, file only two years of audited financial statements instead of three, in 2013 a small majority of companies opted to provide a full three years instead.[30] Additionally, some research has shown that companies that opt for reduced financial disclosure see their IPOs underpriced compared with other issuers.[31] It therefore appears that the market itself has demanded a higher level of disclosure, providing a useful test case to demonstrate both what information is truly valuable to investors and the ability of the market to induce such disclosures without regulatory coercion.

On the other hand, the confidentiality provisions have been enormously popular. Uptake on the option to file confidentially has been high, at 88 percent overall since the JOBS Act was signed into law, with many firms also taking advantage of the opportunity to test the waters with institutional investors.[32] These provisions provide several benefits. First, preparing for an IPO and filing the necessary papers with the SEC is incredibly expensive. If a company is able to test the waters with institutional investors first, it can spend the money for the IPO with confidence that the IPO will be successful. Second, public filing exposes many of the company's secrets, including business model, revenue, expenses, information

"There are indications that the Act has succeeded in increasing the number of IPOs, with the greatest increase among smaller firms and especially among biotechnology firms."

> **"It would benefit all public companies, investors, and the American economy if the SEC required only those disclosures that provided valuable information to the market."**

about its products, and management's view of risks facing the company. A company choosing to go public has calculated that exposing this information publicly, including to its competitors, is worth the opportunity to access the capital markets. If the IPO flops, however, the company has exposed itself for nothing.

In some ways, the confidentiality provisions of the IPO on-ramp seem counterintuitive. The very nature of a public company is that it cannot be secretive. Even without SEC-mandated disclosure, a publicly traded company would need to provide visibility about its operations to shareholders and would-be investors. However, by shifting certain disclosures—including most notably the fact that the company is contemplating an IPO—to just a few weeks later, the company is able to conduct a more accurate cost-benefit analysis regarding the utility of an IPO.

Even though the smallest and youngest companies will not be using the IPO on-ramp any time soon (and some may never opt to go public), the benefits of an improved IPO process inure to companies at every stage. A robust IPO market has several advantages. It reflects economic growth and provides assurance that regulatory barriers are not smothering activity. It has a democratizing effect on wealth-building by enabling non-accredited investors (also known as retail investors) to participate in a company's explosive early growth. And it lowers the cost of capital, including early stage capital, by providing liquidity for investors. A sluggish IPO market can make it especially difficult for start-ups to raise cash. Such early investment essentially locks down investors' money. The longer the path to an IPO, the longer investors must wait, and the longer the lag until they are able to recover their cash and invest in a new venture. The IPO on-ramp is therefore especially important to the start-up model small business that must raise cash in a few large injections to make the leap from one stage of growth to the next.

The IPO on-ramp ultimately makes only minimal changes to the IPO process. After five years of going public, a company that uses the on-ramp will have the same reporting and compliance requirements that any other public company has.[33] Although regulation generally operates as a ratchet, moving only toward more regulation, in this case regulation was loosened, with limited ill effects and with promising indications of positive results.[34]

Policy Recommendations

The IPO on-ramp provides not just a single alternative IPO process, but a menu of options from which an issuer may choose. The selection process provides valuable insight into what features are useful to issuers and what features are irrelevant given market pressures. The fact that the confidentiality features appear to be especially attractive to biotechnology companies, who face substantial risk in exposing company secrets during the IPO process, suggests that a one-size-fits-all approach to disclosure may be harmful to capital formation.

It would benefit all public companies, investors, and the American economy if the SEC required only those disclosures that provided valuable information to the market. There is currently no mechanism to systematically revisit and evaluate the effectiveness of the disclosures the SEC requires of public issuers. The effectiveness and lack of evidence that fraudulent offerings increased following the introduction of Title I of the JOBS Act shows that parts of the current mandatory disclosure regime are unnecessary.[35] What other parts are equally useless? What serves only as a drag on the economy? A good start to finding out would be a one-time review by the SEC of the current disclosure regime accompanied by a commitment to repeal any requirements that are not shown to be effective. A better start would be to commit to repeating this process on a regular basis to ensure that whatever disclosures the SEC requires are indeed providing value to the market.

TITLE II: PRIVATE PLACEMENTS

Of the many exemptions from registration available under the federal securities laws,

the exemption for private placements is the 800-pound gorilla. This exemption allows issuers to offer securities to a select group of investors, known as "accredited" investors, comprised principally of institutions and wealthy individuals. While the public capital markets receive the most attention, private placements are a key driver of capital access for companies of all sizes. Although the rules for their use are complex, the process is simpler and cheaper than the process for a public offering. While public companies can and do use private placements, the majority of these offerings tend to be in the $1–5 million range, indicating wide usage by small, privately-held companies. Private placements are *the* way that small companies sell securities to raise capital.

Title II of the JOBS Act liberalizes both the way in which a company doing a private placement may advertise its offering to potential investors and the way in which securities bought in a private placement may be advertised in the secondary market. Given the large role private placements play in funding small companies, principally through investment by venture capital funds (VCs) and angel investors, but also in friends and family rounds, these changes may prove significant.

How Private Placements Are Used

The securities laws make a distinction between "public" and "private" offerings. Public offerings are those made to the general public. Private offerings are those made to a more select group of potential investors. Finding the line between public and private can be tricky—how select does the select group have to be for the offering to qualify as non-public? The vast majority of private placements therefore use a set of rules set out in the SEC's Regulation D that provide what is known as a "safe harbor." A safe harbor is a legal provision that states that certain conduct will be assumed not to violate a particular law. It is the rules that make up this safe harbor (and, very specifically, how the rules define "non-public") that the JOBS Act changes. In order to understand the impact of the changes in Title II of the JOBS Act it is necessary first to understand something about how Regulation D works. Although Regulation D includes several rules with varying requirements under which an offering may qualify for the exemption, the most commonly used, by far, is Rule 506.[36]

The sine qua non of the registered public offering is its large volume of mandatory disclosures. A company preparing for an IPO often spends millions of dollars compiling specific pieces of information required by law to be provided to the SEC and the public in conjunction with the sale of its securities. Thereafter, the company must spend millions more dollars providing updates on this information to the public (and the SEC) on a quarterly and annual basis. The SEC has estimated that the average cost of continuing annual regulatory compliance for public companies was $1.5 million in 2014.[37] The purpose behind these disclosures is to ensure that the investing public has the information it needs to make informed investment decisions.

The presumption underlying Rule 506 is that certain investors, because of wealth or access to information, do not need the protections of the disclosures required in a registered offering.[38] And an offering to them may therefore be done under the private placement exemption. Under 506(b), the securities may be sold to no more than 35 "non-accredited investors" and an unlimited number of "accredited investors." Accredited investors include those investors who are presumed able to "fend for themselves" in obtaining necessary information from the company to make an informed investment decision.[39] These investors include institutional investors, a director or executive of the issuer, or a wealthy individual whose assets (excluding primary residence) exceed $1 million or who, alone, earns more than $200,000 annually or $300,000 annually jointly with a spouse.[40]

Non-accredited investors are individuals who nonetheless have "such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment, or the

> **"The vast majority of private placements use a set of rules set out in the SEC's Regulation D that provide what is known as a 'safe harbor.'"**

> "The restrictions on general solicitation put many companies in a bind—how to find accredited investors if the company is barred from advertising for them?"

issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description."[41] Additionally, sales to these individuals must be accompanied by significant disclosures outlined in Regulation D.[42] The rationale for these disclosures is that, unlike accredited investors, non-accredited investors—even those who have "experience in financial and business matters"—are presumed to lack the financial sophistication necessary to request the relevant disclosures from the issuer.[43] Because the purpose of most offerings under Rule 506 is to avoid costly disclosures, these offerings are typically limited to accredited investors in order to dispense with the obligation of providing the mandated disclosures for non-accredited investors.[44]

Unlike other exemptions in the securities laws, there is no limit on the amount of money an issuer can raise using Rule 506 of Regulation D, and it is available for use by public companies.

In addition to restricting who may buy the securities, Rule 506 restricts how an issuer may contact potential buyers. Before Title II of the JOBS Act became effective, issuers relying on Rule 506 were barred from "general solicitation."[45] In interpreting what constitutes a general solicitation, the SEC has taken a broad view. The rule states that general solicitation includes, but is not limited to, "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and . . . [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising."[46] Generally, if the issuer has a "preexisting and substantial relationship" with anyone to whom the securities are offered, the SEC will find that there was no general solicitation.

One of the major challenges for companies raising capital through a private placement is attracting investors. A large, established company will have a ready network of brokers and interested investors, something smaller companies, and small young companies in particular, lack. The restrictions on general solicitation therefore put many companies in a bind—how to find accredited investors if the company is barred from advertising for them? There have traditionally been a few options. A company whose owners have wealthy friends or family can tap the owners' personal networks. There is also considerable informal investment in the small business world, much of which is not in compliance with the securities law. Small business owners may obtain investment from friends and family who are not accredited, often without the small business owner or the investors realizing they are engaging in a securities transaction and certainly without knowledge that they are doing so in violation of the law.

Issuers can also use a middleman: a broker can act as an intermediary to connect issuers with investors. Brokers, knowledgeable about their client's assets and therefore whether they qualify as accredited investors, and having a preexisting business relationship with their clients, may contact clients who may have an interest in certain private placements the broker knows are seeking investors. However, brokers typically receive a portion of the sales proceeds as a fee, and most small offerings are too small to attract the interest of intermediaries; only 13 percent of Regulation D offerings from 2009 to 2012 reported using a broker.[47]

There also are investors who intentionally seek out promising new companies with the intention of providing funding via private placement. Venture capital funds are perhaps the best-known of this type of investor. Venture capital firms seek to invest in high-growth companies that can bring an IPO to market in a few years, providing a substantial return on investment.

These companies are generally highly scalable, offering exponential growth if successful. Obtaining VC funding is something of a Holy Grail in the start-up world, but such funding is difficult to obtain. In 2010, for example, 505,473 new companies were incorporated in the U.S. but only 1,095 companies received venture capital funding.[48] Because the funds are looking for a large return, given the riski-

ness of the investment, a business model that is not particularly scalable will not be attractive to venture capital.[49]

Moreover, some companies do not want venture capital. In exchange for what is a large investment, given the relatively small size of the company, VC typically takes a considerable equity stake, diluting existing shareholders (usually the company's founders). One corporate development consultant estimated the average VC equity stake to be approximately 70 percent of the company.[50] Venture capitalists also take a hands-on approach to managing their investment, often taking at least one seat on the company's board of directors and actively guiding the company's management.

For some start-ups, this involvement is a feature, not a bug. If the company's founders are inexperienced, either because of youth or general unfamiliarity with the ins and outs of running a company, they may welcome the guiding hand of VC's well-seasoned executives. But other founders may prefer to keep a firm grip on the company's reins and may therefore eschew VC interference in day-to-day operations and strategic planning.

In addition to the considerations above, venture capital may be inappropriate for a company due to the stage in its development. Because VC is generally looking for an exit in the near term—IPOs backed by venture funding in 2010 had received six years of support on average—these funds are typically interested in what might be called mature start-ups, those companies that are likely to have their biggest growth ahead of them but that have shown their mettle through initial growth and development of a healthy revenue stream.[51] A very young company, one that has yet to launch its product or generate any revenue, would generally be too immature for VC investment.

Companies seeking very early stage investment, often called "seed money," may turn to "angel" investors. Angels are individuals, or small groups of individuals, who invest smaller sums of money in brand new ventures. Where a VC might invest several million, an angel might invest $50,000 or $100,000, or even as little as $30,000. While all investors are looking for a return on investment, angels are generally also motived by an interest in helping new companies and fostering entrepreneurship. Angels themselves are frequently successful entrepreneurs who see this form of investing as a way to give back by identifying and supporting promising new entrepreneurs.

The form of an angel investment may also differ from the form of VC investment. Whereas VC firms almost always take an equity stake, an angel may take equity or debt, but often prefers convertible debt, which incorporates some of the most attractive features of each.[52] The amount of guidance an angel provides will vary with the angel-company relationship. Some angels are interested in providing a great deal of expertise and guidance (which many companies are thrilled to have since such expertise may be extremely expensive if a company were to buy comparable services), while others are happy to take a more hands-off approach. Although angel investment can be a boon to new companies, it, like venture capital, can be difficult to secure. In 2010, 61,900 companies received angel investment, representing a little more than 12 percent of the total new businesses started that year, with an average investment of about $325,000.[53] Angel investing has, however, been on the rise. In 2006, for example, the Bureau of Labor Statistics reported 667,341 new enterprises; but only 51,000 received angel funding, or about 7.6 percent.[54]

Angel investing has existed in some form throughout time. Beginning in the 1990s, however, angels began to form groups to seek investment opportunities. By forming a network, angels can more effectively connect with entrepreneurs seeking their help. With the advent of the Internet, some of these angel networks went online. To comply with the pre–JOBS Act ban on general solicitation, websites listing investment opportunities required investors to register and confirm their accredited investor status before viewing the offerings.

The result of the restriction on advertising has been to require a relationship-based

"Venture capitalists take a hands-on approach to managing their investment, often taking at least one seat on the company's board and actively guiding the company's management."

"Society at large has been deprived of new inventions and the benefits they bring only because of where the inventors lived."

approach to selling securities through private offerings. People must actually know people in order for the sales to work. This has resulted in great geographic concentration. Investors tend to invest in companies geographically close to them. The investors, brokers, and issuers have therefore all been grouped close together, historically in California, New York, and Boston.[55] This means that innovations in other parts of the country may be starved of funds for no reason other than geographic accident. It also means that society at large has been deprived of new inventions and the benefits they bring only because of where the inventors lived.

Secondary Market for Securities Sold in Private Placements

The secondary market for securities sold through a private placement is also quite limited. The federal securities laws require not only that offerings be registered, but that securities themselves be registered as well, unless, as with offerings, they qualify for an exemption. Securities sold through a public offering are registered as part of the offering process. But securities bought through a private placement are not registered, and are therefore "restricted." They cannot be resold unless the sale qualifies for an exemption.[56] This restriction increases the price of capital raised through a private placement. A less liquid security will carry a higher premium to entice investors to effectively lock up their money.

One exemption from the registration requirement is for "transactions not involving an issuer, underwriter, or dealer."[57] This seems like an easy solution—wouldn't most investors, trading amongst themselves, fall into this category? Unfortunately, no. The securities laws define "underwriter" so broadly that steering clear of the underwriter designation has made trading restricted securities very tricky to navigate. The Securities Act includes in its definition of an underwriter "any person who has purchased from an issuer with a view to . . . the distribution of any security[.]"[58] The intent behind this interpretation is clear: if a security could be bought in a private placement and immediately resold to any investor, including any member of the public, the distinction between public and private offering would evaporate. But how to distinguish between the investor who bought a security for investment and one who purchased it with a "view to [its] distribution"?

Because this definition requires the SEC to peer into the mind of the investor to determine whether the investor bought the security with "a view to [its] distribution," the law has developed to use certain behaviors as a proxy for determining what the investor's intent may have been at the time of purchase. Most notably, the SEC has found the length of time between the initial purchase from the issuer and the sale in the secondary market to be relevant to the initial purchaser's intent.[59] To further remove uncertainty surrounding the underwriter designation, the SEC issued a rule in 1972 that creates a safe harbor for the resale of securities issued under the private placement exemption. Under Rule 144, an investor who holds a restricted security for six months if the company is a reporting company or a year for other companies may resell the security without being deemed an underwriter.

While Rule 144 provided some liquidity for restricted securities, a holding period of six months or a year is still a burden. Also, if the intent behind the underwriter designation for shorter holding periods was to prevent the security from immediate transfer into the hands of retail investors, it would seem that sales between accredited investors should be permitted. In 1990 the SEC issued Rule 144A. This rule allows restricted securities to be offered in the secondary market to "qualified institutional buyers," or QIBs, without a holding period.[60] Qualified institutional buyers are, in general, institutional investors that own and invest on a discretionary basis at least $100 million in securities, and dealers who own and invest on a discretionary basis at least $10 million in securities.

Note, however, that the rule requires restricted securities not only to be sold only to

QIBs, but also to be *offered* only to QIBs. To understand the difficulty this restriction has imposed, it is important to understand what, exactly, "offer" means.

The definition of "offer" under federal securities law is notoriously broad. The Securities Act of 1933 states that "[t]he term . . . 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[61] This already broad definition has in turn been interpreted broadly by the SEC. A communication need not even expressly offer the securities for sale for it to be considered an offer. According to the SEC:

> The publication of information and statements, and publicity efforts, generally, made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort.[62]

Google famously had to delay its IPO because an interview its founders Larry Page and Sergey Brin gave to *Playboy* magazine arguably "contribut[ed] to conditioning the public mind or arousing public interest" in the IPO.

So, private placements, while vital to companies' ability to access investment, nonetheless present some traps for the unwary. Moreover, many of the restrictions focusing on *offer* versus *sale* provide minimal benefit, if any, but have imposed substantial costs on issuers, investors, and on our economy as a whole, which benefits from companies' ability to obtain the capital to grow.

JOBS Act Changes to Regulation D

Title II of the JOBS Act radically reforms the rules for solicitation of investors in both the primary and secondary markets for private placements. It directs the SEC to issue new regulations lifting the ban on general solicitation for Rule 506 offerings, specifically "to provide that the prohibition against general solicitation or general advertising . . . shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors."[63] It also directs the SEC to change Rule 144A to allow offers to non-QIBs: "to provide that securities sold under such revised exemption may be offered to persons other than qualified institutional buyers, including by means of general solicitation or general advertising, provided that securities are sold only to persons that the seller . . . reasonably believe[s] is a qualified institutional buyer."[64] This means that private placements and securities sold in private placements can be offered, that is, advertised, *anywhere*. Television, billboards, banner ads on websites, cold calls, sky-writing airplanes flying over crowded beaches—it's all okay. (Although, of course, these changes apply only to offers; actual sales remain restricted to accredited investors and QIBs.)

In September 2013, the SEC adopted final rules implementing these changes. Under these rules, the SEC created two versions of Rule 506 offerings: the traditional Rule 506 offering, which retains the prohibition on general solicitation and permits a limited number of non-accredited investors; and a new offering under Rule 506(c), which permits general solicitation but requires that issuers sell only to accredited investors.

Under the traditional Rule 506 offering (now named a "506(b)" offering to distinguish it from the new Rule 506 offering, which appears under Rule 506(c)), investors have typically self-certified their status, via questionnaire or other method. And an issuer, assuming it has a reasonable belief that the investor is indeed accredited, can rely on an investor's assertion that he or she meets the income or net-worth requirements. Under Rule 506(c), however, issuers must take reasonable steps to verify accredited investor status, resulting in more work for the issuer. The SEC has provided a nonexclusive list of methods that

"Title II of the JOBS Act radically reforms the rules for solicitation of investors in both the primary and secondary markets for private placements."

> “Advertising permitted by the new rules may provide opportunities for those small businesses that can leverage existing relationships to raise funds.”

an issuer might use to verify that an investor has the requisite income or net worth; these include reviewing tax documents, bank statements, a report from a nationwide consumer reporting agency, or obtaining written confirmation from an attorney, accountant, broker-dealer, or registered investment adviser.

Result of JOBS Act Changes to Regulation D

As the new rules implementing these changes went into effect only in late 2013, it is difficult to predict definitively the effect they will have on the private market. Although the rules' implementation was much-touted in certain corners of the Internet,[65] many small businesses remain unaware of the changes.[66] Recent data suggest that fewer than 10 percent of Rule 506 offerings are conducted under the new 506(c).[67] Additionally, even with the introduction of online platforms to connect investors with entrepreneurs, the investment process for many investors remains a personalized one. While many angel investors now use platforms to find entrepreneurs, online investment platforms take the place of introductions, not relationships. The process is not unlike online dating. The Internet enables people to search for and connect with others looking for a romantic relationship, but the relationship itself tends to take place offline, in real life. Similarly, angel investors can search for and connect with early stage companies online, but often prefer to meet and talk with the company's founders face-to-face before making an investment.

The changes may, however, expand the population of private placement investors. Not every investor who qualifies as accredited will seek out an angel network to join. But such investors may be drawn in by advertising now permitted by the new rules. This may provide opportunities for those small businesses that can leverage existing relationships to raise funds, expanding the value of those connections.

Consider, for example, a luxury-good purveyor who has an established base of clients who are familiar with the product and with the company itself. The company may decide to seek investment from its customers, whom it knows include a number of individuals with the requisite income or assets and who may be interested in investing in *this* company, although they may not have sought out such investments in the past. Or consider other built-in investor audiences: alumni networks, local community members, subscribers to a niche-interest publication. Investing platform North Capital Private Securities recently announced that it will be using an online Rule 506(c) offering to raise $30 million to partially fund a giant Ferris wheel to be built on Staten Island.[68] These investors will not be angels, in that they are unlikely to provide the mentorship that often accompanies an angel investment, but they may be interested in supporting a company affiliated with their personal interests.

There is also the possibility of developing Web-based platforms geared toward specific interests. The platform 1031 Crowdfunding, for example, permits investors to find one another to exchange investment real estate to take advantage of a provision in the tax code.[69] Finally, although many existing angels may prefer to meet company executives in person before investing a sizeable sum, some may take advantage of the efficiencies of online investing to invest much smaller amounts—a few hundred dollars perhaps—in companies purely via online platforms. While $500 is not going to get any company off the ground on its own, multiple $500 investments could do the trick.

While the new 506(c) offering may provide greater opportunities for both investors and issuers, there are reasons a company may opt to select the traditional 506(b) offering instead. First, the issuer's relationship with the investor can be somewhat different in a 506(c) offering than in a 506(b) offering. On the one hand, the issuer in a 506(c) offering will have access to documents and information about the investor's financial situation that a 506(b) issuer would not have. Because 506(b) allows investors to self-certify that they are accred-

ited, issuers would have no cause to review investors' tax or financial documents, documents that must be reviewed by a 506(c) issuer looking to use the rule's safe harbor. On the other hand, the issuer in a 506(c) offering ultimately may have less information about, and control over, the investors than a 506(b) issuer would have. Consider the method each uses to solicit investment. In the 506(c) offering, the issuer is likely to use the Internet or some other method of general solicitation (this is, after all, the raison d'être of the 506(c) offering). The issuer is using this method of attracting investment specifically because it allows the company to reach investors otherwise unknown to it. While this provides greater reach, it also means that the investing relationship will not be quite as close as the relationship between an issuer and investor who either already had a preexisting substantial relationship themselves or were introduced through a trusted intermediary. One of the advantages of being a privately-held company is the ability to control who owns you; choosing general solicitation as a means of finding investors risks ceding this control.

Second, the issuer in a 506(c) offering must choose what to disclose publicly as part of its general solicitation, navigating between the Scylla of exposing company secrets to a wide audience (including competitors) and the Charybdis of committing securities fraud. Any offering of securities, including one made pursuant to Rule 10b-5, is subject to Rule 10b-5, the federal securities laws' catch-all fraud provision. This rule makes it illegal to:

> Employ any device scheme or artifice to defraud, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading, or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.[70]

While it requires some attention to detail, most issuers acting in good faith can refrain from making untrue statements of material facts. It is trickier to ensure that disclosures do not leave out necessary information, the omission of which may make them misleading. To see the difference, consider, for example, a manufacturing company with two factories. It would be plainly misleading to state that the company had three factories when it had only two. But what if the second factory was currently shut down due to a broken piece of machinery that would cost $1 million to replace? Now the company, if it discloses the existence of two factories (where clearly manufacturing capability is a material fact), must also disclose the fact that one is currently shut down and will require $1 million to fix so that its statements are not misleading.

The traditional 506(b) private placement does not require any specific disclosures if the offering is limited to accredited investors. But the investors typically receive a private placement memorandum (PPM), which includes all the information the issuers feel the investors would want to know before investing in the company. While the information can be quite sensitive, it is not made publicly available and is provided only to those eligible to invest in the company. As discussed in the context of the IPO on-ramp earlier, the ability to keep information secret from competitors is one of the great advantages of remaining a privately-held company.

It may be that issuers conducting a new 506(c) offering will choose to provide interested investors with a private placement memorandum. But it is unlikely that they will want to make it widely available. While any company conducting any kind of offering can fall afoul of Rule 10b-5, it will be especially challenging for a company to provide sufficient information to entice investors through general solicitation while simultaneously ensuring the information is not misleading due to an omission.

As with Title I, the changes that Title II makes to the securities laws are relatively

"The ability to keep information secret from competitors is one of the great advantages of remaining a privately-held company."

> "The current definition of accredited investor is too limited. The best solution would be to permit individuals to make their own decisions about how they want to spend their money."

small—506(c) offerings are still available only to accredited investors, and securities sold through these offerings are still restricted. But they provide a flexibility that will enable new companies that might have otherwise been shut out of the market for reasons unrelated to the quality of their business models to access capital. And they allow investors new opportunities and options in allocating their funds and permit those outside the venture capital hot spots to influence the development of new products and services through investment. The 506(c) offering may appeal equally to an established company and to a start-up. Most important may be the company's ability to convert existing relationships into investment or to appeal to an audience broader than what has traditionally been the source of early stage investment. While less glamorous than Title III, which creates the new crowdfunding exemption, Title II may result in a greater impact on capital access.

Policy Recommendations

The current definition of accredited investor is too limited. The best solution would be to do away with the accredited/non-accredited distinction entirely, and permit individuals to make their own decisions about how they want to spend their money. In the alternative, the accredited investor standard should be revised to ensure it reflects an investor's actual ability to evaluate an investment. Wealth alone has little bearing on whether a person is well-informed, or even well-advised, on investment matters. Even if it did, using a fixed number with no reference to variances in cost of living gives preference to people living in certain parts of the country. It also favors age over other measures of experience. Under existing law, for example, a retired physician living in New York City might be able to invest in a start-up developing new mining technologies while a young mining engineer, who is much better informed about mining itself and about the industry in general, would be excluded.

The current method of calculation also excludes the primary residence. This recent change means that two people, each with say $2 million, would be treated differently if one chose to buy a $1.5 million house and invest the rest, while the other decided to rent a house and invest the whole $2 million. Each would have the same net worth, but the investment the first individual made in a house would not be considered in the same way that the second individual's first $1.5 million investment would be considered.

The accredited investor calculation should be revised to again allow investors to include the value of the primary residence. There should be an additional method of qualifying as an accredited investor that allows an individual to demonstrate knowledge of basic finance and investing concepts. Finally, an individual should be able to invest in specific offerings upon a showing that the investor has knowledge of the issuer's industry. A certain amount of work experience in that industry, a professional qualification, or a university-level degree in a field directly related to the issuer's industry would be presumed to confer the relevant knowledge.

TITLE III: INVESTMENT CROWDFUNDING

Title III of the JOBS Act is by far the most ambitious of the act's titles. While every other title simply tweaks elements of existing securities law, Title III, through a collection of interwoven exemptions, creates an entirely new kind of offering. Included in its exemptions are: an exemption for the offering from registration under Section 5 of the Securities Act of 1933 even though it is an offering to the public; an exemption for the company from registration under the Securities Exchange Act of 1934 even if the company would otherwise trigger the requirement that it register once it exceeds a certain number of shareholders of record; and exemption from registration as a broker-dealer for a new type of entity, the "funding portal." The novelty of this title, and the genesis of this collection of exemptions, have created a number of challenges for

the SEC in developing implementing regulations—challenges that, to a large extent, remain unresolved.

Origins of the Crowdfunding Exemption

The genesis of a crowdfunding exemption was not the SEC or even the financial industry. Its origins lie in the tech start-up world. In 2006, a new version of an old concept emerged, built on the Internet's ability to radically reduce transaction costs across a wide geographic area. In its current incarnation, the concept is called "crowdfunding." In general, crowdfunding refers to a means of raising funds by which small amounts are solicited from a large number of people.

The concept predates the Internet by hundreds of years. Long before the Internet was developed, people took up "subscriptions," commitments to provide small amounts of money, to support public projects. Arguably the Statue of Liberty itself stands in New York Harbor thanks to a "crowdfunding" project.[71] The Internet, however, has made this method easier to use, as reaching hundreds or even hundreds of thousands of people has become extremely cheap. A number of platforms have sprung up to facilitate the process. The most prominent is Kickstarter, followed closely by Indiegogo and Rockethub, among others. While these platforms tend to focus on actual projects, others such as GoFundMe allow individuals to seek funding for almost any purpose.[72]

In recent years, even before passage of the JOBS Act, a number of companies have turned to crowdfunding to obtain seed money. Because of existing securities regulation, however, companies are currently restricted in how they may use crowdfunding. They may solicit money from individuals, and they may provide benefits in exchange for that money—but not offer investment. Successful crowdfunding campaigns have included preferred status on a waitlist for the forthcoming product, a T-shirt, or a handwritten letter of thanks from the company's founder.[73] They may not, however, offer a means by which investors can receive a return on investment.[74] Given the nature of the rewards that companies may offer, the type of company that can currently use crowdfunding successfully is limited. Generally only a company with a certain level of charisma, either because it offers an innovative consumer product or because it exudes a coolness that people find attractive, will be successful in attracting this type of capital.

Frustrated by the inability to use crowdfunding more broadly, several entrepreneurs initiated a campaign to create an exemption to allow investment crowdfunding for small businesses.[75] With the assistance of the Sustainable Economies Law Center, a nonprofit organization focused on developing local economies, they submitted a proposal for rulemaking to the SEC.[76] Other entrepreneurs drafted proposed legislation, which they presented to lawmakers in late 2010.

This was when two very different worlds—the entrepreneurial world and the deeply complex world of SEC regulation—collided. Part of the appeal of crowdfunding is its grassroots nature. Early proponents of investment crowdfunding remarked on how ludicrous it was that such a simple form of investment was illegal.[77] The investment crowdfunding concept was therefore intended to be extremely simple. The proposal submitted to the SEC envisioned a $100,000 cap on the offering and a $100 limit per investor. It suggested that issuers might be a local café looking to expand, a community garden, or a bookstore interested in adding a stage and public address system for small performances—all very small businesses whose owners may not have a high level of financial sophistication. Embedded in the concept was the idea that issuers could do a crowdfunded offering without the raft of legal and financial experts typically needed for even a small private offering, and certainly without the army of experts employed by the issuer planning an IPO.

How the Crowdfunding Exemption Will Work

Unfortunately, given the complexity of the federal and state securities laws and their at-

"Early proponents of investment crowdfunding remarked on how ludicrous it was that such a simple form of investment was illegal."

> "Given the cost of professional assistance, any money raised under this exemption becomes extremely expensive and most issuers will likely find other exemptions more attractive."

tendant regulations, even a simple exemption for a very simple type of offering cannot ultimately be done simply. Although the exemption is entirely new, it is built into the same complex securities law framework that has existed for the last 80 years. The version of the exemption that was ultimately included in the JOBS Act will require, for most issuers, some professional guidance to navigate successfully. This may be its downfall. There is a $1 million cap on any offering using this exemption. Given the cost of professional assistance, any money raised under this exemption becomes extremely expensive and most issuers will likely find other exemptions more attractive.

The new exemption works as follows. A company may offer up to $1 million in securities, whether debt, equity, or some combination, to the general public over the course of one year without registering the offering with the SEC, provided the offering meets all of the requirements to qualify for the exemption. These include the following: the issuer may not be a public company and must be a U.S. entity. The issuer must provide certain information to the SEC, including the issuer's name and address, the identities of its officers and directors, and a description of the issuer's business plan. It must also disclose its financial condition, provide financial statements and information regarding its capital structure, and disclose how much it wants to raise, what it will do with the proceeds, and what the price of the securities will be. The issuer must meet its full funding goal for the raise to close; if it fails to meet its target by a set deadline, no sales occur.

After the offering closes, the issuer must comply with ongoing reporting requirements. It must make annual disclosures to the SEC and its investors regarding business operations, and must produce its financial statements.

The exemption also imposes certain restrictions on investors. Prospective investors must pass a financial literacy test, which must include an acknowledgment of the fact that the investor could lose the entire investment. The amount any one investor may invest in crowdfunding securities in one year is capped at an amount based on the individual's annual income and net worth, but investment for any investor, regardless of wealth, is capped at $100,000 annually.

Finally, the offering must be made through either a registered broker or dealer, or through a new entity termed a "funding portal." Under the Securities Exchange Act of 1934, any person "engaged in the business of effecting transactions in securities for the account of others,"[78] or "engaged in the business of buying and selling securities" for that person's own account[79] is a broker or dealer and therefore must register with the SEC.[80] Registration as a broker or dealer is an onerous process. It requires registration with the SEC itself and with the Financial Industry Regulatory Authority (FINRA). While nominally a private entity, FINRA functions in a quasi-governmental role, writing and enforcing a number of rules for the financial services industry, the violation of which can result in loss of license and fines. Among FINRA's rules for broker-dealers are that broker-dealers and their employees must pass certain examinations, written and administered by FINRA; that the broker-dealer must maintain established capital levels; and that the broker-dealer is subject to a fiduciary duty standard in certain transactions and relationships, exposing the broker-dealer to substantial litigation risk.

The JOBS Act provides an exemption from these requirements for persons "acting as an intermediary in a transaction involving the offer or sale of securities for the account of others"[81] as long as those transactions are exclusively within the crowdfunding exemption. But the funding portal loses its designation—and therefore its exemption—if it provides investment advice; solicits purchases, sales, or offers for the securities on its platform; pays commissions for the sale of the securities it has listed; or holds or manages investor funds or securities.

This is not to say that, by virtue of being exempt from registration as brokers or deal-

ers, funding portals are unregulated. In fact, Title III clearly intends for funding portals to act as gatekeepers for the crowdfunding industry. They must register with the SEC and with FINRA, provide investor education, ensure that investors do not exceed the individual investment cap, and protect confidential information. They are also given the task of ensuring that funds are not released to issuers until and unless they have reached their funding target.

Then there are the anti-fraud provisions, which apply both to funding portals and to issuers. Both are subject to the wide-ranging liability of Rule 10b-5. Additionally, the JOBS Act includes a provision creating a new cause of action specific to crowdfunding offerings, imposing liability on the issuer for a material misstatement or omission of a required statement. Once again, the securities laws interpret a term so broadly as to create a number of regulatory hurdles. Although "issuer" would seem to apply only to the company actually issuing the securities, in fact the securities laws define issuer to include the company, its directors and partners, its principal executive, and its financial and accounting officers.

The definition of "issuer" also includes "any person who offers or sells the security in such offering."[82] The Supreme Court has construed the term "issuer" broadly enough that a funding portal arguably falls within the definition of "seller" in this context.[83] Unlike Rule 10b-5, which requires a finding of *scienter*, or an intent to defraud, the new provision in the JOBS Act requires no such intention; if there is a finding that there was a material misstatement or omission, liability attaches unless the seller can show that reasonable due diligence would not have uncovered the error. Of course, that does not mean that any misstatement will result in liability. The misstatement must be "material," which, under the securities laws, means that there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[84]

The Final Rules

How this exemption will work in practice is yet to be seen. The exemption requires implementing regulations from the SEC and FINRA, and the SEC only just issued final rules in October 2015, which will become effective on May 16, 2016—several years after the JOBS Act directed the SEC to issue regulations.[85]

Neither the delay nor the exemption's complexity is surprising. The concept of investment crowdfunding was met with considerable apprehension, by lawmakers and by some within the industry and academia, when first proposed.[86] Securities regulation exists, in part, to protect investors. If portions of the rules are rolled back, one of two things must happen: either investors lose needed protection and are thereafter defrauded or otherwise unjustly parted from their wealth, or those portions of the rules were unnecessary and therefore many assumptions underlying the architecture of the securities laws are incorrect.

One of those assumptions is that any offering sold to the public must provide certain required disclosures. Under this assumption, the SEC must prescribe the disclosures because retail investors are not sophisticated enough to know what information they should request before investing. There is some validity to this assumption. Many retail investors may not know enough about corporate finance or governance to know what information exists, never mind which pieces of information they should consider before investing. The benefit of having the information provided through SEC-mandated disclosures is that every company's filing will look similar, making it easy for the investor to compare disclosures across companies.

While it may be beneficial for some investors to have assistance in obtaining information about potential investments, it is not clear that all of the disclosures required for a public company would be valuable for a potential crowdfunding investor. Despite the talismanic properties sometimes attributed to this body of disclosures, it is unlikely that a crowdfunding investor looking to invest $100

"It is not clear that all of the disclosures required for a public company would be valuable for a potential crowdfunding investor."

> **"The final rules have significant defects, all of which derive from using a template created for large public companies to develop a regulatory regime for extremely small offerings."**

or $1,000 would benefit from such a large volume of information.

Additionally, SEC-mandated disclosures are not the only way for an investor to obtain information. The nature and structure of crowdfunding encourages information-sharing and engagement. Some in the industry argue that there will be no fraud in crowdfunding because the "crowd"—that is, the online investing community—will quickly identify and report fraudsters.[87] Such a blanket dismissal of the risk of fraud is naïve, as there is nearly always fraud where there is money to be made, but the ability of investors and potential investors to share information seamlessly online will likely check some illicit activity. The proposed rules include a specific provision allowing for communication through the funding portal, including communication between the issuer and investors.[88] Moreover, the issuer's ability not only to provide information to investors, but to interact and engage with them, offers a new means of responding to specific requests. An issuer need not anticipate all investors' requests and satisfy them with one data dump. The disclosures can be an ongoing, interactive process.

As for the need for guidance in understanding what information is relevant to making an informed investment decision, the SEC is not the only source for such assistance. Private sector actors can provide help, too. For example, CrowdCheck (of which the author is a founder and owner) is a company founded specifically to help investors conduct the due diligence necessary to making an informed decision when investing in a crowdfunding offering.

The second assumption behind the securities laws' approach to protecting retail investors is that they must be prevented from investing in companies and participating in transactions deemed to be risky. The near ban on retail investment in private placements is the best example of this type of investor protection. The IPO process itself functions as another such restriction. The process of conducting an IPO is almost entirely focused on preparing, filing, and disseminating disclosures. The disclosure process therefore also serves a gatekeeping function in that only certain companies—generally those that are above a certain size and relatively well established—will find an IPO worthwhile. Seen through this lens, the burden of preparing for an IPO is a plus. It weeds out the smaller, younger, riskier companies and thereby prevents retail investors from investing in them.

Given these assumptions, it is not surprising that, before the JOBS Act, there were no meaningful opportunities for retail investors to invest in a company at the very start of its lifecycle. The fact that retail investors have not typically been a part of this market has made the task of designing appropriate regulations for crowdfunding offerings difficult. The exemption does not work if the issuer must make the same disclosures it would make for an IPO. Those disclosures are simply too burdensome for offerings and companies of this size. The exemption would be unusable.

Although the SEC has sought to balance these concerns and develop a workable exemption, it does not seem to have been successful. The final rules have significant defects, all of which derive from using a template created for large public companies to develop a regulatory regime for what are extremely small offerings. For example, the rules require issuers to follow U.S. Generally Accepted Accounting Principles (GAAP). Among other requirements, this requires the use of accrual-based accounting. In accrual-based accounting, debits and credits are recorded as they accrue. If, for example, a company orders inventory in June with payment due in August, the debit is recorded in June. Most small businesses, however, use cash-based accounting, in which credits and debits are recorded as the money flows into or out of the company's accounts. Under cash-based accounting, the inventory ordered in June but paid for in August would be recorded in August.

In some ways, accrual-based accounting provides a more accurate picture of the company's financial situation. If a company has $50,000 in cash on hand but must pay $45,000

in the next few weeks, it is more accurate to say that the company has $5,000 rather than $50,000. In a large company that always has a number of substantial orders and payments outstanding, accrual-based accounting is essential to understanding the company's health. In a very small company, however, there are likely to be only a small number of credits or debits outstanding and disclosing individually any that are of significant size is easily done. Accrual-based accounting is unnecessary.

Under the rules, issuers must also make annual disclosures to the SEC and on the company's own website until the company goes out of business or acquires all of the outstanding crowdfunding securities it issued. An issuer must therefore calculate the cost, not only of preparing for the offering itself, but also of annual disclosures on an ongoing basis.

The SEC, in accordance with administrative law, first published proposed rules on which the public was invited to comment, and subsequently issued the final rules. While it is the agency's prerogative to make changes to final rules as it sees fit, some of the changes between the proposed and final rules for Title III were surprising. For example, the final rules have introduced a risk that a crowdfunding issuer may be forced to register as a public company. Most companies go public by choice, but a provision of the securities laws mandates that a company register with the SEC if it has more than 2,000 shareholders or 500 non-accredited shareholders, and $10 million in assets.[89] It is essential to the crowdfunding model that an issuer be able to raise money from a crowd of investors. Requiring issuers to register as public companies if they have more than 500 non-accredited investors, including crowdfunding investors, would make the crowdfunding exemption unworkable and would fundamentally undermine its premise.

The proposed rules therefore included a provision that would not count crowdfunding investors toward the 500-shareholder total. Unfortunately, the final rule introduces a risk. The issuer can exclude the crowdfunding investors, but only if it complies with certain requirements. If the issuer, for example, misses filing its ongoing disclosures, it loses the exemption, meaning that it would have to file as a public company if it has more than 500 non-accredited investors. This could wreak havoc with small crowdfunding issuers. In the tumult that characterizes the daily operations of a start-up, where a handful of people fill the roles that require dozens at a larger enterprise, and where legal and compliance issues may fall to the overburdened CEO, missing an SEC filing is a real possibility. Even if one believes that these ongoing filings are necessary to investor protection, a single lapse should not invalidate the exemption for all crowdfunded securities the company has issued.

Not all of the changes to the proposed rules were bad, however. For example, the proposed rules had prohibited platforms from using subjective criteria to select the offerings listed on their sites. The rationale was that such curation was akin to making investment recommendations—I've listed *this* security on my site because it's a good investment and you should therefore buy it—and that platforms should not engage in such activities. Commenters, however, rightly noted that this was in considerable tension with the liability such platforms will shoulder and the structure of the act, which places them in a gatekeeping role for the industry. Under the final rules, platforms may "[d]etermine whether and under what terms to allow an issuer to offer and sell securities in reliance on Section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)(6)) [the JOBS Act provision that allows crowdfunding] through its platform, provided that the funding portal otherwise complies with Regulation Crowdfunding (§§ 227.100 et seq.)."[90] Funding portals may not make any assertions about the quality of the investments on their sites, but they may use whatever methods they choose to select the offerings they will list. This change provides not only a means for platforms to reduce liability exposure, but also a certain level of investor protection. A platform, by creating a carefully curated list of offerings, can cultivate a reputation for listing only well-run com-

"Requiring issuers to register as public companies would make the crowdfunding exemption unworkable and would fundamentally undermine its premise."

"Both the implementing regulations and the underlying legislation creating the crowdfunding exemption have significant flaws."

panies, making its offerings more attractive to investors and issuers alike and providing a useful service to investors.[91]

Given the complexity of the legislation and of the surrounding securities regulations, it is ultimately unlikely that most issuers will be able to successfully complete a crowdfunding offering without some assistance from legal or financial professionals. With the amount of money a company can raise in a crowdfunding offering capped at $1 million, companies may have little room in the budget to spend on these services. If the cap were raised, which would require an act of Congress, the exemption might be more attractive, but given the changes to Regulation A (described below) and Regulation D, there might simply be no need for Regulation CF (the crowdfunding exemption).

Additionally, crowdfunding involves receiving investment from the crowd or from a large and broadly dispersed group of investors. This means that, for companies that choose to issue equity, any future investment will have to wrangle with a large and unwieldy assortment of shareholders. The easiest solution would be to create a fund that would invest in crowdfunded offerings. Unfortunately, the JOBS Act explicitly forbids the use of special-purpose vehicles (SPVs) or other funds under Title III.[92] Even if funds were permitted, they would need an exemption from the Investment Company Act of 1940, which imposes certain registration and other requirements on funds, to be viable. This is yet another area where the law simply is not built for companies the size of crowdfunding issuers. It is almost impossible that any fund specializing in crowdfunding would be well-funded enough to justify the expense of registration under the Investment Company Act.

With better underlying legislation and better implementing regulation, investment crowdfunding might have provided a useful contribution to capital formation for the smallest companies. Properly done, investment crowdfunding would provide small, quick injections of cash into very early stage or very small companies. For example, a local coffee shop looking to buy new equipment or a two-person start-up needing cash to allow its founders to quit their day jobs and spend a year or two building the business until it can bring in revenue might be good candidates for an effective form of crowdfunding. Unfortunately, the current exemption is too unwieldy to be viable for such uses.

Even so, it is not realistic to believe that, whatever its form, investment crowdfunding would bring quite the number of new ventures and jobs that some of its advocates imagined.[93] In its current incarnation, it is unlikely to change very much at all. However, its greatest benefit may not be its ability to assist in capital formation directly. The greatest benefit the new exemption provides may be the simple fact that it is new. Regulation in general, and securities regulation in particular, has a tendency to discount, and therefore stifle, innovation. Regulation CF is valuable simply in its willingness to venture into the unknown. It is too bad it was not better done, but it opens the door for more innovation in the future.

Policy Recommendations

Both the implementing regulations and the underlying legislation creating the crowdfunding exemption have significant flaws. A few changes, some more ambitious than others, could make crowdfunding a viable option for capital formation:

- Creating a de minimis exemption for crowdfunding. Informal—extralegal—crowdfunding has always existed. It's what happens when someone opens a new restaurant and invites mom, dad, some cousins and a few buddies to "go in on" the restaurant and become "part owners," which is often structured (albeit unwittingly) as a sale of stock and not as the creation of a partnership. These types of arrangements, despite the headaches they give attorneys who later need to unwind the sales, will persist whether they are legally sanctioned or not. Rather than create unnecessary

complexity, it would be simpler to create an exemption for offerings under, for example, $500,000. To the extent investor safeguards were deemed necessary, the exemption could include restrictions either on the amount any one investor could invest (similar to those that exist under Regulation CF) or restrictions on how the offering could be advertised.

- Permitting the use of special purpose vehicles (SPVs) under Regulation CF, removing the restriction on crowdfunding by investment companies, and providing an exemption under the Investment Company Act that would make the creation of a crowdfunding investment fund feasible. This would allow the development of funds created for the purpose of investing in crowdfunding offerings, giving investors the opportunity to diversify and to leverage the expertise of a fund manager. Ultimately, this change would improve investor protection. One of the biggest criticisms of investment crowdfunding has been the fact that the businesses seeking crowdfunding are almost guaranteed to be small and young, and therefore risky. An investor could, instead of holding shares of one risky asset, hold a diverse basket of crowdfunding securities.[94] Additionally, the fund manager would have an incentive to provide more thorough vetting and diligence on the securities to be included in the fund, leading to potentially better investments for the investors. Finally, crowdfunding is, more than most types of investing, about investing in more than simply a business enterprise. Crowdfunding imparts a certain emotional benefit on investors who may invest in a company because of personal beliefs or affiliation. The availability of crowdfunding funds could enable the creation of, for example, a fund comprised of businesses within a specific town, or businesses devoted to a certain cause, allowing investors to invest broadly in places or concepts they cherish.
- Reverting to the proposed rule that would have made all securities issued under Regulation CF exempt from the 12(g) requirements regardless of future behavior on the part of the issuer. The current final rule introduces too much uncertainty and creates a substantial risk that an issuer will be required to file as a public company because of an innocuous lapse in compliance. At the very least, there should be a grace period during which an issuer can cure the deficiency and retain its private status.

TITLE IV: REGULATION A REVISITED—THE BACKDOOR TO CROWDFUNDING

Although most discussion of securities crowdfunding has, understandably, focused on the new exemption in Title III, another exemption can also provide a crowdfunding-like option for issuers. Regulation A is an old exemption in the securities laws, dating back to 1936. It has been dubbed the "mini IPO" because it permits small offerings of freely tradable securities to the general public without full registration with the SEC. It has historically been challenging for companies to use because of the cap on how much can be raised in an offering under this exemption—pre–JOBS Act, the cap was $5 million—and because of restrictions related to state law, which will be discussed in this section. In fact, companies have found it so challenging to use that it has been deemed unworkable and fallen almost entirely out of use.

In 2011, there was only one qualified Regulation A offering. By way of comparison, there were 8,194 Regulation D offerings (private placements) for less than $5 million and even 312 registered public offerings for less than $5 million in the same year. Exemptions from full registration, as Regulation A is, are intended to be easier and more cost-effective than a full public offering. The fact that there were more

“Companies have found Regulation A so challenging to use that it has been deemed unworkable and fallen almost entirely out of use.”

> **“Due to the cost and effort required to respond to SEC questions, many issuers who begin the process of conducting a Regulation A offering never finish it.”**

than 300 times the number of sub-$5 million IPOs in 2011 than Regulation A offerings suggests that Regulation A was not working as intended.[95] Even one of the most robust years for Regulation A, 1997, produced only 56 qualified offerings.[96]

What was wrong with Regulation A? Two things: the $5 million cap and lack of federal preemption. At first blush it seems strange that the $5 million cap would be problematic since there have been IPOs for less than $5 million. The reason is that the lack of federal preemption made the legal and other compliance requirements so costly that they quickly ate into the $5 million issuers were allowed to raise under the exemption.

An offering under Regulation A is, even post-JOBS Act, more complicated than raising money under Regulation D. First, the company must be an eligible issuer. Unlike Regulation D, Regulation A places restrictions on which companies can use the exemption. It cannot be used by a reporting company, that is, a company that has had an IPO, lists its securities on a national exchange, or has more than 2,000 shareholders of record (or more than 500 non-accredited shareholders of record). The issuer must also be either a U.S. or Canadian company. Second, the company must complete a scaled-down version of the more robust registration process required before an IPO. Third, the company cannot, as in the case of Regulation D, raise an unlimited amount of money using this exemption. Finally, the offering must be accompanied by a disclosure document known as an offering circular. An offering circular, while more modest in scope than the prospectus that accompanies an IPO, is nonetheless a significant undertaking requiring the assistance of legal counsel. For example, the circular that accompanied one of the very few recent Regulation A offerings, conducted by Fundrise in 2012, was 40 pages, not including the audited financial statements and seven appended exhibits.

Also, unlike Regulation D, Regulation A is an exclusive safe harbor. In the case of Regulation D, which is not an exclusive safe harbor, an issuer may fail to meet all of the requirements to qualify for the Regulation D exemption and yet still be exempt from registration. Regulation D carves out space in the very vague statutory exemption for issues not involving a public offering. The rationale behind Regulation D is that we will say “well, a lot of things might be a non-public offering, but we will say that if you meet the requirements of this Regulation, your offering will *definitely* be non-public.” Regulation A, however, is not a carve-out within a broader exemption; it *is* the exemption. Any deviation from its requirements means that, if the offering cannot qualify for another exemption and yet is not fully registered, it is in violation of the Securities Act.[97]

Even after the necessary materials have been filed with the SEC, the issuer’s work is not done. The SEC staff review the materials and may return to the issuer with questions and requests for additional information or changes to the offering materials. These changes often must be addressed by the issuer’s lawyers and, in the case of questions about the company’s financial statements, by its accountants. There may be a number of written communications back and forth between the SEC staff and the issuer and its team, plus informal conversations as the details of the offering materials are ironed out. Due to the cost and effort required to respond to SEC questions, many issuers who begin the process of conducting a Regulation A offering never finish it. For example, in 2011, there were 19 initial Regulation A offerings filed but only one qualified.[98]

Lack of Federal Preemption

If issuers had only to comply with federal law, more might have found it worthwhile to meet these obligations to be able to raise a few million dollars. However, they have to comply with state regulations as well. In legal terms, the federal government may, where it has jurisdiction, elect to preempt state law. In 1996, Congress provided federal preemption for a wide range of securities through the National Securities Markets Improvement Act (NSMIA). Pursuant to this act, securities listed on

the New York Stock Exchange and NASDAQ, as well as securities sold in reliance on the Regulation D exemptions, are exempt from state registration requirements.

Securities sold under the Regulation A exemption, however, were not included in the act and have therefore been subject to state registration requirements.

Each state has its own agency that regulates the sale of securities within its borders. These agencies oversee state securities laws, known as "blue sky" laws. At the federal level, every offering of securities must be registered with the SEC, or qualify for an exemption. Similarly, for every offering of securities in the United States, the issuer must register that offering with the state securities regulator, unless the offering either qualifies for an exemption under state law, or federal law has preempted the state's regulation of the offering.

While there are similarities among the 51 jurisdictions (the 50 states plus the District of Columbia), each jurisdiction has its quirks. An issuer subject to these rules must therefore carefully review the laws of each jurisdiction in which it plans to offer securities to ensure compliance. Offering documents must also be submitted to each jurisdiction, and each set of documents must comply with that jurisdiction's requirements, which include not only the content of the required disclosures and filings, but also the format in which these disclosures must be made.

Moreover, a majority of states include "merit review" as part of the offering process. This means that the state securities board reviews the offering to determine whether the terms are, in the words of many state statutes, "fair, just, and equitable" to the investor and, in some cases, ascertains whether the securities are likely to present a return on investment to the purchaser.[99] While the existence of merit review does not necessarily impose additional compliance costs on the issuer, it does introduce uncertainty. An issuer may complete all necessary documentation, comply with all relevant requirements, and incur all applicable costs associated with preparing an offering for a particular state only to be rejected by the state securities board as too risky.[100] Even if the state board accepts the offering, however, the process at the state level typically mimics that at the federal level, requiring several rounds of communication between issuer and regulators, and the input of the issuer's lawyers and accountants. Each iteration costs both time and money for the issuer.

Certainly one reason for the paucity of Regulation A offerings is the availability of Regulation D. As discussed earlier, Regulation D has no cap and requires no specific disclosures. There is no back-and-forth with the SEC, and no risk that the offering will not be accepted (although, of course, any offering carries the risk of liability if it fails to comply with regulations). Regulation D offerings also benefit from federal preemption. And, now that Rule 506 offerings may be advertised via general solicitation, the public nature of Regulation A offerings may be even less attractive. Regulation D offerings tend to be cheaper than Regulation A offerings. While the cost of each can vary considerably based on the size of the offering, the complexity of the issuer, and other factors, a pre–JOBS Act Regulation A offering tended to cost somewhere around $100,000 while a Regulation D offering can sometimes be done for as little as $20,000 or $40,000.

Given the benefits of a Regulation D offering, why would a company choose Regulation A? There are two reasons. First, securities sold pursuant to a Regulation A offering are freely tradeable in the secondary market. This liquidity increases their value and lowers the cost of capital. Second, issuers are not indifferent to who buys their securities, especially when the company is very small.

Fundrise, for example, is a real estate development company that, according to its website, seeks to "democratize local investment" by facilitating investment in real estate by local investors. Given the company's mission, having unaccredited but local investors for its projects is crucial to its vision. The company has used Regulation A in the past to enable un-

"An issuer may complete all necessary documentation, comply with all relevant requirements, and incur all applicable costs only to be rejected by the state securities board."

> **"The Regulation A filing process took six months to complete, required the assistance of eight attorneys, and cost more than $50,000 in legal fees."**

accredited investors to participate in its offerings. However, it found the exemption's compliance requirements unworkable. According to Fundrise, the filing process took six months to complete, required the assistance of eight attorneys, and cost more than $50,000 in legal fees.[101] The company also notes that its final filing document weighed 25 pounds. Until recently, it had reverted to relying exclusively on accredited investors and Regulation D offerings. In late 2015, however, it announced a new Regulation A offering, under the new post-JOBS Act rules.[102]

As for that sole Regulation A offering in 2011, its issuer has also spoken out about the challenges of complying with the regulation's requirements and with numerous state regulatory regimes. The 2011 Regulation A offering was for $5 million to fund a Broadway revival of the musical *Godspell*. In an interview at the time, the lead producer, Ken Davenport, expressed his interest in having "a community of investors since the musical is about a community of people."[103] This community came at a cost, however. Davenport later recounted the efforts required to comply with various state regulatory regimes. Texas requested a $250,000 bond, he reported, while Maryland required that he pass FINRA's Series 63 Uniform Securities State Law Examination.[104] The legal and other costs of completing the $5 million raise, he said, totaled $200,000. Although The Godspell LLC successfully completed its round of funding, other production companies have not followed suit, preferring to use the more efficient Regulation D exemption to fund Broadway shows.

JOBS Act Changes to Regulation A

Title IV of the JOBS Act aimed to revitalize this exemption by raising the cap to $50 million, with a periodic review to determine if the cap should be raised further, and by classifying the securities sold under the exemption as "covered" if offered or sold to "qualified purchasers." Under the Securities Act of 1933, a covered security is exempt from state registration requirements.

Qualified purchaser is a term that has been around for a while but that has never been definitively defined. As part of the process of drafting rules to implement this title of the JOBS Act, the act directed the SEC to define this term and, in the end, the SEC defined the term quite broadly indeed. First, the SEC created two tiers of offerings under Regulation A. Tier 1 looks a lot like old Regulation A, but with a $20 million cap instead of a $5 million cap. Offerings must comply with all Blue Sky (that is, state) laws, but ongoing reporting requirements are minimal and financial statements need not be audited unless the company has already prepared audited statements for other purposes. (As many state regulators require audited statements, most issuers using Tier 1 will wind up needing audited financials in the end.) Anyone can buy securities sold in a Tier 1 offering and can invest as much money as they wish.

Tier 2 offerings, meanwhile, have a $50 million cap and are exempt from state registration requirements. However, financial statements must be audited. Additionally, Tier 2 offerings impose ongoing reporting obligations, including semi-annual and annual reports, and reports necessary to ensure information is current. Non-accredited investors may invest only 10 percent of the greater of income or net worth in any one offering.

Finally, under Tier 2, securities may only be offered and sold to "qualified purchasers." The final rule states that a qualified purchaser is "any person to whom securities are offered or sold pursuant to a Tier 2 offering of this Regulation A."[105] That is to say, anyone at all. The SEC could not have defined the term any more broadly than this.

The SEC's liberality has not gone unchallenged. Several state regulators, through their representative association, the North American Securities Administrators Association (NASAA), have objected to the SEC's definition of qualified purchaser, arguing that the SEC's interpretation is "clearly contrary to the plain language and intent of the applicable statutes."[106] State officials from Montana and

Massachusetts have filed suit against the SEC, seeking to enjoin the agency from permitting offerings to go forward under the new rules. These suits are currently pending.

Although the SEC certainly acted boldly in defining qualified purchaser as it did in Tier 2 offerings, its actions are supported by a careful consideration of the JOBS Act. The purpose of the JOBS Act is "to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[107] Congress included changes to Regulation A in the act, liberalizing its terms. The act also included a provision ordering the Government Accounting Office (GAO) to conduct a study on "the impact of State law regulating securities offerings, or 'Blue Sky law,' on offerings made under Regulation A."[108] The GAO study concluded that state registration requirements were "costly and time-consuming for small businesses" and that Regulation D's federal preemption made that exemption more attractive for small issuers.[109] Congress's inclusion of the GAO study in the JOBS Act ties the changes to Regulation A to issuers' concerns with state-level compliance. The GAO's findings confirm that the lack of federal preemption for Regulation A contributed to small companies' strong preference for Regulation D. It is therefore neither arbitrary nor capricious for the SEC to conclude that broad federal preemption would promote the goals of the JOBS Act.

Only a handful of issuers have filed paperwork for Regulation A offerings since the new rules became effective. Some of these filings have fundamental flaws that make it unlikely they will qualify. Some other issuers, however, have filed papers recently or have expressed interest in the exemption but are taking a more measured approach before jumping in. A key consideration for issuers is the speed with which the SEC reviews and qualifies offerings; many companies are unwilling to wait more than 90 days to start fundraising, especially given the fact that Regulation D offerings require no paperwork to be filed with the SEC and no approvals. However, while there is no limit on the amount of capital that can be raised under Regulation D, the limitations Regulation D imposes on investors can make raising larger amounts more difficult. If the SEC can review and qualify the offerings quickly enough, the new Regulation A may be a useful source of capital for companies that need a large injection of funds but that are not quite ready to enter the public markets. This category includes a large swath of small business models. While a successful Regulation A offering does need the assistance of lawyers, the amount that can be raised under the exemption is sufficient to make such an expense worthwhile. It may be that the changes to Regulation A are the most important of all the JOBS Act's provisions.

Policy Recommendations

On the whole, the changes to Regulation A are very welcome and promising. But if the SEC were to make two changes, the new Regulation A would be even more effective:

- extending federal preemption to all Regulation A offerings; and
- providing explicit federal preemption of state Blue Sky laws for registered broker-dealers trading in securities originally issued under Regulation A. Currently, while securities sold pursuant to Regulation A are freely tradable, restrictions remain at the state level on how a registered broker-dealer can handle these securities. Removing those restrictions on secondary trading would make the securities more liquid.

Given the fact that Regulation A's unpopularity was due overwhelmingly to the need to comply with state as well as federal regulators, it seems unlikely that the new Tier 1 offering under the revised Regulation A will be very popular. It is difficult to see how state-level review adds appreciable investor protection, and there is therefore no need for the Tier 1/Tier 2 distinction. The disclosure requirements currently applicable to Tier 1 should apply to all

"It is neither arbitrary nor capricious for the SEC to conclude that broad federal preemption would promote the goals of the JOBS Act."

> "The effect of this change is to permit companies to remain privately held further into their lifecycles or to remain private indefinitely."

Regulation A offerings, including those above $20 million, and all Regulation A offerings should be exempt from state registration requirements.[110]

Additionally, making the initial offering exempt from state registration is, at best, a half measure if the securities cannot be easily traded in the secondary market.

TITLES V AND VI: STAYING PRIVATE LONGER

As discussed earlier, companies typically decide to go public because they need access to the kind of capital that is only available in the public markets. This is a big decision in the life of a company and not one that is taken lightly. In addition to the considerable cost of the IPO and ongoing compliance costs, a public company simply must be run differently than one that is privately held. The company loses control over who holds its stock, and its board and executives now have outsiders looking over their shoulders. Its inner workings, previously open only to shareholders and creditors, are now laid bare for inspection by any member of the public who can access the SEC's online filing system, including competitors. Many companies, although highly successful, choose nonetheless to stay private.

There are, however, circumstances that *require* a company to go public. The two triggers are total assets and shareholders of record; if both exceed an established limit, the company will be considered a public company and must register or be found in violation of the securities laws.[111] Before the passage of the JOBS Act, these thresholds were assets exceeding $10 million and more than 500 shareholders of record. The JOBS Act raises the threshold for shareholders of record to 2,000, as long as these shareholders are accredited; the threshold for non-accredited shareholders remains at 500.

It should be noted that the threshold considers only shareholders *of record* in making the calculation. The distinction between shareholders and shareholders of record is an important one. Most individual investors' securities are held in brokerage accounts. The brokerage is the shareholder of record for these securities, not the brokerage clients, who are the beneficial owners of the securities. Therefore a brokerage may hold shares in a company for 100 account holders (the beneficial owners) but only the brokerage will count as the shareholder of record. In the industry a brokerage holding securities in this way is said to hold securities "in street name" for its clients. So the threshold is actually much higher than it initially appears.

Titles V and VI of the JOBS Act raise the thresholds for, respectively, issuers generally and for bank holding companies specifically to $10 million in assets and 2,000 total shareholders of record or 500 non-accredited shareholders of record. The effect of this change is to permit companies to remain privately held further into their lifecycles or to remain private indefinitely.

This seems to present a paradox: the JOBS Act both promotes early stage IPOs by creating an IPO on-ramp and encourages companies to stay private longer by raising the assets and shareholder thresholds. These goals are not contradictory, however, as they give more flexibility for smaller companies both in how they raise capital and how they govern themselves. Additionally, companies that wait longer to go public and can more carefully choose when an IPO makes sense for their business may present a higher quality IPO at the point they do enter the public markets. And there will always be companies that need to go public. Companies that receive private equity funding, for example, are under a great deal of pressure to provide an exit for their investors. Sometimes this exit can be through acquisition by another company, but often it's through an IPO. Other companies, because of the culture of their industry, may need to go public to demonstrate they have achieved a certain level of success and maturity. These are appropriate reasons for a company to enter the public markets because they depend on the company's own internal decisionmak-

ing. Titles V and VI assist in letting companies make these decisions themselves, in line with their own business models and projections.

Policy Recommendations

The decision to register an offering and to access the public capital markets should be one a company makes because it is in the best interest of the company. It should not be either a step a company is forced to take, or a barrier to growth for companies that do not wish to operate as a public company. Congress should repeal Section 12(g) of the Securities Exchange Act of 1934.

CONCLUSION

The JOBS Act provides some of the innovation and flexibility required to provide adequate capital access for the wide range of small business models that exist in our economy. The JOBS Act achieves this, in large part, by departing from the traditional approach to securities regulation at the federal level. The SEC has a three-part mandate: (1) to facilitate capital formation; (2) to protect investors; and (3) to maintain fair, orderly, and efficient markets.[112] In finding a balance between facilitating capital formation and protecting investors, the SEC has typically taken the position that less-sophisticated, less-wealthy investors are best protected through exclusion from investment in the riskiest companies. And early stage companies are risky. According to data from the Bureau of Labor Statistics, 20 to 25 percent of new businesses failed in the first year during the period 1994 to 2010, and roughly 50 percent fail by the fifth year.[113]

Preventing people from investing in risky companies may protect them from loss, but it also may protect them from gain. Investment *is* risk. People invest to increase their wealth. The reason investment increases wealth is twofold. First, there is the time value of money. Investors buying bonds, for example, allow the issuer to use their money now and forgo using it themselves because the issuer will return the money with interest in the future. Second, there is risk. Investors buying bonds not only forgo the use of the money for a period of time, they also risk losing it if the issuer is unable to repay the money. To make the risk worthwhile, the issuer offers interest. If there is no risk, there is no reward. "Riskiness" does indeed mean that there is a high likelihood of failure, but it also means that, if the business succeeds, the return is likely to be high.

Before the JOBS Act, the ability of the least-sophisticated, least-wealthy investors—retail investors—to invest in very early stage companies was almost nonexistent. Meanwhile, the investment available to early stage companies was similarly limited. Some have argued that these limitations are beneficial. There is concern that adverse selection will leave only the companies that have been rejected elsewhere to seek investment through online offerings, whether through 506(c) of Regulation D, Regulation A, or Regulation CF. Or that the ability to solicit investment online will attract outright fraudsters to prey on investors. Will there be fraudsters? Almost assuredly. As mentioned above, where there's money, there's fraud. But thieves never needed legitimate exemptions for an opportunity to dupe would-be investors; they can ply their cons online with or without Regulations A, D, or CF. As for adverse selection, this assumption at best betrays a certain stuffiness—is there anything worthwhile on that Internet thing?—or at worst, elitism. The availability of online investing provides improved access for both investors and issuers who reside outside the financial strongholds of the northeastern and Pacific cities. Some issuers may go online as a last resort, but many may choose to offer securities online because of its convenience, ability to reach a broader audience, and because the issuer or its potential investors are young enough that they expect to do everything online (and preferably from their smartphones).

The JOBS Act has made some changes that may open up such investment to new investors. The JOBS Act, however, is far from perfect:

"Preventing people from investing in risky companies may protect them from loss, but it also may protect them from gain."

> “Instead of approaching new technology as a jungle that needs to be tamed by government intervention, regulators should look for ways to remove obstacles to economic growth.”

- While Title I streamlines the IPO process, the question remains whether many of the deferred disclosures are necessary at all.
- Title II makes it easier for issuers to find investors for private placements, but offerings are still largely restricted to accredited investors and there is little to support the notion that a certain level of income or assets renders a person either financially sophisticated or especially knowledgeable about any given industry.
- Title III crowdfunding will be hamstrung by the very low $1 million cap on the amount that an issuer can raise, and most issuers will likely find the ongoing reporting requirements and other disclosures to be unduly onerous, especially given the other options presented by Regulations A and D.
- Title IV provides a much-needed update to Regulation A and Tier 2 will likely prove to be valuable. However, a better solution would have been to provide full federal preemption for all offerings under the exemption. It is unclear what benefit state review of these offerings provides and, for any offering, merit review is anathema to a properly functioning market, as demonstrated by Massachusetts's regulators' inability to recognize the value in the Apple IPO.
- Titles V and VI will assist companies by making the decision to go public one that the company can make based on its own business needs, although it is unclear that requiring a company to go public at any point provides benefits either to the company, its shareholders, or the market as a whole.

Clearly, the JOBS Act is not all that is needed to provide robust growth in the small-business sector. As new technology emerges and innovation in connecting investors with issuers follows, additional changes will be needed. The JOBS Act, however, provides a useful template for how regulators can work to accommodate regulation to the needs of the market instead of the other way around. Instead of approaching new technology as a jungle that needs to be tamed by government intervention, a better approach, attempted but not fully realized in the JOBS Act, would be for regulators to look for ways to remove obstacles to economic growth. This is especially true in the small-business sector, where firm diversity and quick proliferation of new ideas requires equally nimble financial solutions.

APPENDIX A: SUMMARY OF POLICY RECOMMENDATIONS

Title I

The SEC should:

- Establish a process for determining whether disclosures required as part of the IPO process are valuable to the market and whether their value merits the burden of compliance.
- Use this process to conduct a review of the current IPO process, with the goal of repealing requirements that are unduly burdensome.
- Conduct regular reviews of existing and new requirements using these criteria, repealing requirements that are unduly burdensome.

Title II

Eliminate the accredited/non-accredited investor distinction or, if that is not possible, Congress should:

- Broaden the current definition of accredited investor to include individuals who can demonstrate through a brief and simple test an understanding of basic finance and investment concepts.
- Create a new category that would include individuals who can demonstrate, through work experience, a professional qualification, or a university-level degree in a relevant field, knowledge of a specific industry. These individuals would

be eligible to invest in companies within each individual's area of expertise.

- Permit the primary residence to be included in the calculation of accredited investors' assets.

Title III

Congress should:

- Create a de minimis exemption for offerings under $500,000 that would require no filings with, or disclosures to, the SEC. Restrictions on how much an investor can invest and/or on advertising of the offering could be included if necessary.
- Lift the restriction on crowdfunding investment companies and create an exemption under the Investment Company Act to permit such funds to operate with limited registration and disclosure requirements.

The SEC should:

- Remove the conditionality from the 12(g) exemption to ensure that any securities properly issued under Regulation CF remain exempt, regardless of the issuer's compliance with ongoing disclosure requirements (or anything else).

Title IV

The SEC should:

- Extend federal preemption to all offerings under Regulation A.
- Provide explicit federal preemption of state Blue Sky laws for transactions in the secondary market by registered broker-dealers for securities properly issued under Regulation A.
- Apply the disclosure regime currently applicable to Tier 1 offerings to Tier 2 offerings.

Titles V and VI

- Congress should repeal the requirement that companies must register once they have reached a certain shareholder and asset threshold.

APPENDIX B: SUMMARY OF OFFERINGS DISCUSSED IN THIS PAPER

Note: Nothing in this Appendix or in any other part of this paper should be considered legal advice. Anyone wishing to offer or buy securities should consult appropriate legal counsel.

	IPO with on-ramp	Reg. D Rule 506(b)	Reg. D Rule 506(c)	Reg. A	Reg. CF (crowdfunding)
Issuer	Any company with less than $1 billion in annual revenues willing and able to register with the SEC and fulfill ongoing filing obligations. May be U.S. or foreign.	Registered or unregistered companies, U.S. or foreign	Registered or unregistered companies, U.S. or foreign	U.S. and Canadian companies not currently registered with the SEC (i.e., not public)	U.S. companies not currently registered with the SEC (i.e., not public)
Investors	Any, including retail	Accredited or up to 35 non-accredited but financially sophisticated	Accredited only	Any, including retail	Any, including retail
Solicitation	Any	No general solicitation. May only solicit investors known to be accredited or may use intermediary.	Any	Any, although any materials used to “test the waters” must be filed with the SEC	May advertise anywhere but content of advertisements strictly limited. Most information may only be made available on the platform (funding portal)
Cap on Raise	None	None	None	$20 million per annum for Tier 1 and $50 million per annum for Tier 2	$1 million per annum
Cap on Investment	None	None	None	For Tier 2 only, capped at greater of 10 percent of annual income or net worth for non-accredited	Capped at $2,000–$100,000 depending on investor income and assets
Trading in Secondary Market	Freely tradable	Restricted	Restricted	Freely tradable, although registered broker-dealers may be subject to state-level Blue Sky restrictions on how they may handle the securities.	Limitations on resale for one year after issue, freely tradable thereafter

Continued next page

Appendix B *Continued*

	IPO with on-ramp	Reg. D Rule 506(b)	Reg. D Rule 506(c)	Reg. A	Reg. CF (crowdfunding)
Required Disclosures and Filings	Registration statement with offering, including prospectus and audited financials. Must file annual 10-K, quarterly 10-Q, 8-K as needed, and proxy statements. Certain officers must disclose holdings and transactions in company securities.	None required for accredited investors although private placement memorandum may be used at time of offering. Specific disclosures required for non-accredited investors.	None required	Offering circular with mandated disclosures. For Tier 2, must file annual, semi-annual, and specified "current" disclosures.	Specific disclosures required by statute at time of offering with ongoing annual disclosures thereafter
Pros	• Deep market • Securities freely tradable (and therefore may be more valuable) • Can use options or stock to pay employee or to make acquisitions • Liquidity for early investors and for employees paid in stock options	• No cap on raise • No mandatory disclosures if offerees are accredited • No ongoing disclosure requirements • Can rely on self-certification of accredited status if issuer reasonably believes investor is accredited	• Can advertise offering anywhere to anyone, including online • No cap on raise • No mandatory disclosures • No ongoing disclosure requirement	• Streamlined process vs. IPO • Can offer and sell to anyone • Tier 2 offerings have full federal preemption • Securities potentially freely tradable	• Can offer and sell to anyone • Much lower regulatory burden than IPO and lower than Reg. A • Low $1 million cap
Cons	• Very expensive both at the outset and on an ongoing basis • Must comply with any new regulations or requirements imposed on public companies • Highest level of liability; strict liability in some cases • Requires disclosure of sensitive company information to the public • Company can no longer control who becomes a shareholder (i.e., owns the company)	• Can only solicit accredited investors • Securities are not freely tradable	• Can sell only to accredited investors • Must verify accredited status • Securities are not freely tradable	• Limit on raise • No federal preemption for Tier 1 • Ongoing reporting requirements for Tier 2 • Cap on per investor investment for Tier 2 • Liability for mislead-ing statements includes imposition of burden of proof	• Sufficiently complex to require some professional assistance • Ongoing reporting requirements • Strict limitations on how offering may be advertised • For the most part, securities cannot be resold for one year • Risk that slip-up could result in losing 12(g) exemption • Liability for misleading statements includes imposition of burden of proof

NOTES

1. White House Office of the Press Secretary, "Remarks by the President on the Economy," news release, May 13, 2010, https://www.whitehouse.gov/the-press-office/remarks-president-economy.

2. "Supporting Small Businesses and Creating Jobs," Office of Management and Budget, 2013, https://www.whitehouse.gov/omb/factsheet/supporting-small-businesses-and-creating-jobs.

3. For a review of the role of individual entrepreneurship in American social thought on prosperity, see Jim Cullen, *The American Dream: A Short History of an Idea that Shaped a Nation* (Oxford: Oxford University Press, 2002).

4. "Small Business Profile," Small Business Administration, 2014, p. 1, https://www.sba.gov/sites/default/files/files/UnitedStates13(1).pdf.

5. Karen Mills and Brayden McCarthy, "The State of Small Business Lending," Harvard Business School Working Paper no. 15-004, July 22, 2014, p. 6, http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf.

6. Marshall Lux and Robert Greene, "The State and Fate of Community Banking," Harvard Kennedy School Mossavar-Rahmani Center for Business and Government Working Paper Series no. 37, February 2015, p. 22, http://www.hks.harvard.edu/content/download/74695/1687293/version/1/file/Final_State_and_Fate_Lux_Greene.pdf.

7. Karen Mills and Brayden McCarthy, "The State of Small Business Lending," p. 5.

8. Very small companies often fail to realize they are selling securities when, for example, the owner's aunt puts in some money and in exchange becomes a part owner.

9. "Summary of Size Standards by Industry Sector," Small Business Administration, https://www.sba.gov/content/summary-size-standards-industry-sector.

10. Small Business Act of 1953 § 632.

11. "IRS Faces Several Challenges as It Attempts to Better Serve Small Businesses," Government Accountability Office, Tax Administration, August 2000, p. 3, www.gao.gov/archive/2000/gg00166.pdf.

12. This is the definition provided by the main trade association representing small businesses, the Small Business and Entrepreneurship Council. "Small Business Facts and Data," Small Business and Entrepreneurship Council, 2015, http://www.sbecouncil.org/about-us/facts-and-data/.

13. Although some companies, particularly startups, may use credit cards to supplement capital, most small business owners use them as a cash management tool. Congressional Oversight Panel, Emergency Stabilization Act of 2008, "May Oversight Report: the Small Business Credit Crunch and the Impact of the TARP," at p. 12 (2010) (Conf. Rep.).

14. National Small Business Association, "2014 Year End Economic Report," February 19, 2015, p. 11, http://www.nsba.biz/wp-content/uploads/2015/02/Year-End-Economic-Report-2014.pdf.

15. "Availability of Credit to Small Businesses, September 2012," Federal Reserve Board of Governors, http://www.federalreserve.gov/publications/other-reports/availability-of-credit/September-2012-Providers-of-Credit-to-Small-Businesses.htm.

16. National Small Business Association, "2014 Year End Economic Report," February 19, 2015, p.11, http://www.nsba.biz/wp-content/uploads/2015/02/Year-End-Economic-Report-2014.pdf.

17. "What SBA Offers to Help Small Businesses," Small Business Administration, https://www.sba.gov/content/what-sba-offers-help-small-businesses-grow.

18. The Small Business Administration, a federal agency, offers some programs to assist small businesses in securing loans. In general the programs operate through traditional lenders, providing a guarantee for qualifying small businesses. This allows the bank to issue a loan to a borrower with a higher risk profile without increasing the bank's exposure.

19. National Federation of Independent Businesses, "The Small Business Lending Crisis," *Trends Magazine*, September 2014, p.7.

20. The average SBA small business loan is approximately $371,000. Natale Goriel, "6 Step Guide—How to Get a Business Loan," *U.S. Small Business Association* (blog), September 4, 2013, https://www.sba.gov/blogs/6-step-guide-how-get-business-loan.

21. Marshall Lux and Robert Greene, "The State and Fate of Community Banking," p. 11.

22. "Bank Failures in Brief," FDIC, https://www.fdic.gov/bank/historical/bank/; David Wheelock? "Have Acquisitions of Failed Banks Increased the Concentration of U.S. Banking Markets," *Federal Reserve Bank of St. Louis Review* 93 (2011): 155, https://research.stlouisfed.org/publications/review/11/05/155-168Wheelock.pdf.

23. Marshall Lux and Robert Greene, "The State and Fate of Community Banking," p. 11.

24. Michael Kowalik et al., "Bank Consolidation and Merger Activity Following the Crisis," *Federal Reserve Bank of Kansas City Economic Review* 100, no. 1 (2015): 7.

25. The final vote was 390 to 23 in the House and 73 to 26 in the Senate. Pete Kasperowicz, "House Approves JOBS Act in 390–23 Vote," *The Hill*, March 8, 2015, http://thehill.com/blogs/floor-action/house/214979-house-passes-jobs-act-sends-to-senate; Seung Min Kim, "Senate Passes JOBS Act with Tweak," *Politico*, March 22, 2015, http://www.politico.com/story/2012/03/senate-passes-jobs-bill-with-tweak-074363.

26. Jumpstart Our Business Startups Act (JOBS) Act §§ 77-78 (2012).

27. Michael Dambra, Laura Casares Field, and Matthew T. Gustafson, "The JOBS Act and IPO Volume: Evidence That Disclosure Costs Affect the IPO Decision," *Journal of Financial Economics* 116, no. 1 (2015): 122.

28. "Rebuilding the IPO On-Ramp, Putting Emerging Companies and the Job Market Back on the Road to Growth," Securities and Exchange Commission IPO Task Force, October 20, 2011, pp. 10–13, 19, https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

29. Median offering expenses in the period 2007 through 2014 were $3,001,000. Of these, $1,463,500 were legal fees and $867,500 were accounting fees. WilmerHale, "2015 IPO Report," p. 8, https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2015-WilmerHale-IPO-Report.pdf.

30. Skadden Arps, "2014 Insights: a Collection of Commentaries on the Critical Legal Issues in the Year Ahead," (2014), p. 8, http://www.skadden.com/sites/default/files/publications/Skadden_Insights_2014.pdf.

31. Tiffany Westfall and Thomas Omer, "The Unintended Consequences of Emerging Growth Company Status on IPO: Auditor Risk and Effort, Valuation, and Underpricing," working paper, Social Science Research Network, April 14, 2015, p. 2 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2512605.

32. From implementation of Title I of the JOBS Act in April 2012 through the end of 2014, 93 percent of life science companies, 94 percent of tech companies, and 88 percent of all other companies that filed as EGCs chose to utilize the confidentiality provision. WilmerHale,"2015 IPO report," p. 9, https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2015-WilmerHale-IPO-Report.pdf.

33. Jumpstart Our Business Startups Act (JOBS) Act §§77-78 (2012). A company may lose its EGC status sooner if it has $1 billion in annual gross revenues, it issues more than $1 billion in nonconvertible debt in the previous three years, or is deemed to be a large accelerated filer as defined in 17 C.F.R. § 240.12b.

34. To the extent that EGCs find the cost of underpricing to outweigh the benefits of other features of the IPO on-ramp they may either opt not to file as EGCs and therefore use the IPO process as it existed pre–JOBS Act and that still must be used by non-EGCs, or opt to file as EGCs but provide selective additional information such as the market suggests is valuable (which is what seems to be happening in the case of increased financial statement disclosure beyond the required two years).

35. The year 2014, with 169 federal securities class actions, was among the lowest since the 1995 Private Securities Litigation Reform Act. PriceWaterhouseCoopers, "Coming into Focus, 2014 Securities Regulation Study," April 2015, p. iii, https://www.pwc.com/us/en/forensic-services/publications/assets/2014-securities-litigation-study.pdf.

36. More than 99 percent of Regulation D offerings use Rule 506. Vladimir Ivanov and Scott Bauguess, "Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012," Securities and Exchange Commission, July 2013, https://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf.

37. "Proposed Rules: Crowdfunding," *Federal Register* 78, no. 214 (November 5, 2013), p. 66509 (col. 2); David Burton, "Reducing the Burden on Small Public Companies Would Promote Innovation, Job Creation, and Economic Growth," Heritage Backgrounder #2924, June 20, 2014, http://www.heritage.org/research/reports/2014/06/reducing-the-burden-on-small-public-companies-would-promote-innovation-job-creation-and-economic-growth#_ftn10.

38. The rationale behind exempting people with a certain level of wealth from the protections offered by a registered offering is two-fold: (1) people with a large amount of money can more easily absorb a loss; and (2) money buys advice and therefore wealthy people are more likely to have access to paid advisers who can substitute for mandated disclosure.

39. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). The Securities Act states that its registration requirements do not apply to transactions "not involving any public offering." In *Ralston-Purina*, the U.S. Supreme Court found that a transaction not involving a public offering was one in which the investors were able to fend for themselves. In the particular facts before the case, the Court found that rank-and-file employees of Ralston-Purina had no special ability as employees to obtain information about the company and therefore their purchase of company securities was a transaction involving a public offering.

40. 17 C.F.R. § 230.501(a). It is important to note the effect these thresholds have on geographic diversity of investors. Given the higher costs of living in cities such as New York and San Francisco, for example, and the attendant higher salaries at all levels, there will be more people in these locations who earn $200,000 annually than in lower cost of living areas. A company located in Nashville or Omaha may have a smaller pool of potential investors, even controlling for differences in population size, just because salaries tend to be lower in these areas.

41. 17 CFR § 230.506(b)(2)(ii).

42. 17 CFR § 230.502(b)(2).

43. In practice, these presumptions are flawed. A person can be very wealthy and yet have little understanding of finance or business. Another person may have a deep understanding of finance or of the issuer's relevant industry and yet lack $1 million in assets.

44. Only 10 percent of reported Regulation D of-

ferings in the period from 2009 to 2012 included non-accredited investors. Even if the accredited investors ultimately ask for the same disclosures the rule would require for non-accredited investors, the disclosures may be cheaper. This is because any legally mandated disclosure requires an extra level of review, typically by attorneys, to ensure strict compliance with the regulations. A voluntary disclosure, on the other hand, must be accurate but need not conform to any specific regulatory regime. Ivanov and Bauguess, "Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012."

45. 17 C.F.R. § 230.502(c).

46. Ibid.

47. Ivanov and Bauguess, "Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009–2012. It should be noted that the SEC uses data from Form D, which must be filed in conjunction with a Regulation D offering. Many issuers, and their counsel, follow the strictures of Regulation D to ensure that the offering is likely to be deemed non-public but do not file Form D, often out of a desire to keep the offering truly private (i.e., away from the SEC's scrutiny). Therefore there are likely additional offerings not included in these calculations.

48. "Business Employment Dynamics," Bureau of Labor Statistics, May 7, 2014, http://www.bls.gov/bdm/entrepreneurship/bdm_chart1.htm; National Venture Capital Association and Thomson Reuters, "2015 Yearbook," March 2015, p. 58, http://nvca.org/research/stats-studies/.

49. An example of a business model unlikely to attract venture capital is a professional services company. The profit margin on one hour of billable time will always be the same, whether the company bills 10 hours or 10 million hours. In comparison, an app developer may invest several million in creating a product, but after the development costs have been recouped, the profit margin will increase substantially as more units are sold.

50. John Mecke, "How Much Equity do VCs Really Get?" *DevelopmentCorporate* (blog) February 1, 2010, http://www.developmentcorporate.com/2010/02/01/how-much-equity-do-vcs-really-get/.

51. National Venture Capital Association and Thomson Reuters, "2015 Yearbook," p. 58.

52. Convertible debt reduces downside risk, does not immediately dilute the current shareholders, and offers considerable upside if the company does well.

53. Bureau of Labor Statistics, Business Employment Dynamics, "Entrepreneurship and the U.S. Economy," http://www.bls.gov/bdm/entrepreneurship/bdm_chart1.htm; Jeffrey Sohl, "The Angel Investor Market in 2010: A Market on the Rebound," Center for Venture Research, http://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/2010_analysis_report_0.pdf.

54. Bureau of Labor Statistics, "Entrepreneurship and the U.S. Economy"; Sohl, "The Angel Investor Market in 2010."

55. "More than 49 percent of the U.S.-based companies financed by venture capital firms are located in San Francisco, Boston, and New York, which suggests that venture capital plays a primary role in fostering entrepreneurial communities in their home regions." Josh Lerner, "Geography, Venture Capital, and Public Policy," policy brief, Harvard Kennedy School of Government policy brief, March 2010, p. 1, http://www.hks.harvard.edu/index.php/content/download/68616/1247274/version/1/file/final_lerner_vc.pdf.

56. Securities Act of 1933 § 4.

57. Ibid.

58. Securities Act of 1933 § 2(a)(11).

59. Lloyd S. Harmetz, "Frequently Asked Ques-

tions About Rule 144a," Morrison & Foerster, 2009, p. 3, http://media.mofo.com/docs/pdf/faq rule144a.pdf.

60. 17 C.F.R § 230.144A(a).

61. Securities Act of 1933 § 2(a)(3).

62. "Publication of Information Prior to or After the Effective Date of a Registration Statement," Securities Act Release No. 33-3844, 22 Fed. Reg. 8359 (Oct. 8, 1957).

63. JOBS Act Title II, § 201(a)(1).

64. JOBS Act Title II, § 201(a)(2).

65. See, for example, Roger Trivelli, "How SEC Regulation D 506(C) Will Truly Effect Start Up Companies," Evancarmichael.com, http://www.evancarmichael.com/library/roger-trivelli/How-SEC-Regulation-D-Rule-506c-will-truly-effect-startup-companies.html; Samuel Guzick, "Preparing for Regulation D-Day," *Crowdfunding Insider* (blog), September 17, 2013, http://www.crowdfund insider.com/2013/09/22880-preparing-for-regula tion-d-day/.

66. According to a report by the Milken Institute and the National Center for the Middle Market, only 4 percent of small and mid-sized businesses are aware of the availability of general solicitation for private offerings. The Milken Institute and the National Center for the Middle Market, "Access to Capital: How Small and Mid-Sized Businesses Are Funding Their Future," May 11, 2015, p. 7, http://www.milkeninstitute.org/publi cations/view/706.

67. Vladimir Ivanov, "Capital Raising Through Regulation D," presentation, Securities and Exchange Commission, Government-Business Small Business Forum, Washington, D.C., November 19, 2015, Kevin Laws, "Online Fundraising and Syndicates," presentation, Securities and Exchange Commission, Washington, D.C., November 19, 2015. It should be noted that neither presentation captures all Rule 506 offerings. Ivanov, who is a senior financial economist at the SEC, drew his data from Form D filings. Form D is not required for Regulation D offerings and therefore a survey of Forms D will not present a complete picture. Laws presented data only from offerings listed on his company's platform.

68. Randall Smith, "Crowdfunding a $500 Million Ferris Wheel, With a Wall Street Spin," *New York Times*, September 7, 2015, http://www.ny times.com/2015/09/08/business/dealbook/crowd funding-a-500-million-ferris-wheel-with-a-wall-street-spin.html.

69. See "About Us," 1031 Crowdfunding, http://www.1031crowdfunding.com/about; and Tony Zerucha, "JOBS Act Energizes Real Estate Market for 1031 Crowdfunding," *Bankless Times* (blog), September 8, 2015, http://www.banklesstimes.com /2015/09/08/jobs-act-energizes-real-estate-mar ket-for-1031-crowdfunding.

70. 17 C.F.R. § 240.10b-5.

71. See, for example, "The Statue of Liberty and America's Crowdfunding Pioneer," BBC News Magazine, April 25, 2013, http://www.bbc.com/news/magazine-21932675.

72. The Kickstarter campaigns that have received the highest levels of funding include a smart watch, a cooler, a card game, a video game console, and an effort to revive the children's television program Reading Rainbow. Nina Zipkin, "The 10 Most Funded Kickstarter Campaigns Ever," *Entrepreneur.com*, March 30, 2015, http://www.en trepreneur.com/article/235313. The most popular GoFundMe campaigns have focused on assisting families with medical bills or providing support to children who have lost parents, but other campaigns have included projects such as making a Baltimore woman's "relentlessly gay" yard "more gay." "The Most Successful GoFundMe Fundraising Campaigns," GoFundMe, http://www.go fundme.com/most ; Elisa Lala, "Woman Launches GoFundMe to Make 'Relentlessly Gay Yard' More Gay," *Philly Voice* (blog), June 22, 2015, http://www.phillyvoice.com/woman-make-her-relentlessly-

gay-yard-more-gay-/.

73. One example is Pebble Watch, a highly touted smartwatch product whose creators raised capital through Kickstarter. In exchange for funding, the firm offered pre-sale of the watch. "Pebble Time—Awesome Smartwatch, no Compromises," Kickstarter, December 3, 2015, https://www.kickstarter.com/projects/597507018/pebble-time-awesome-smartwatch-no-compromises.

74. Ensuring that a company is not offering a "security" can be more challenging than simply ensuring that it is not selling stock or bonds. According to the U.S. Supreme Court, a security is an investment of money in a common enterprise due to an expectation of profits depending solely on the efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

75. This has been called "equity crowdfunding" by many in the industry, but that term is misleading. Under the crowdfunding provision of the JOBS Act, companies will be able to issue both equity and debt. It is likely that debt, and not equity, will be the more popular form of investment for companies issuing securities under this exemption. Given the companies' risk profiles, the founders' preference for maintaining control of the company, the illiquidity of this type of stock, and the "messy cap table" problem discussed on page 22, debt or, potentially, convertible debt is likely to be more attractive to investors and issuers alike.

76. Jenny Kassan, "Exempt Securities Offerings up to $100,000 with $100 Maximum per Investor from Registration," SEC Petition for Rulemaking, July 2010, http://www.sec.gov/rules/petitions/2010/petn4-605.pdf.

77. See, for example the "Change Crowdfunding Law Blog," which was housed at crowdfundinglaw.com. This blog was managed by Paul Spinrad, an editor at *Wired* magazine, and was updated frequently from 2010 to 2015.

78. Securities Exchange Act of 1934 § 3(a)(4)(A).

79. Securities Exchange Act of 1934 § 3(a)(5)(A). This definition does not include "a person that buys or sells securities for such person's own account . . . but not as a part of a regular business." Securities Exchange Act of 1934 § 3(a)(5)(B).

80. Securities Exchange Act of 1934 § 15(a).

81. Securities Act of 1933 § 4A(a).

82. Securities Act of 1933 § 4A(c)(3).

83. See *Pinter v. Dahl*, 486 U.S. 622, 640–47 (1988).

84. Basic, Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

85. Securities and Exchange Commission, "Crowdfunding Rules," *Federal Register* 80, no. 220 (November 16, 2015): 71387–615, http://www.gpo.gov/fdsys/pkg/FR-2015-11-16/pdf/2015-28220.pdf.

86. Carl Levin, "Statement Submitted to the Committee on Banking Housing and Urban Affairs," United States Senate Hearing 112-444, Spurring Job Growth Through Capital Formation, December 1, 2011, https://www.gpo.gov/fdsys/pkg/CHRG-112shrg74738/html/CHRG-112shrg74738.htm; "They Have Very Short Memories," *New York Times*, March 10, 2012, http://www.nytimes.com/2012/03/11/opinion/sunday/washington-has-a-very-short-memory.html; John Coffee, "Statement Submitted to the Committee on Banking Housing and Urban Affairs," United States Senate Hearing 112-444, Spurring Job Growth Through Capital Formation, December 1, 2011, https://www.gpo.gov/fdsys/pkg/CHRG-112shrg74738/html/CHRG-112shrg74738.htm.

87. Mark Sanchez, "Crowd Control? Social Nature of Crowdfunding Should Control Fraud, Advocates Say," MiBiz, April 25, 2013, http://mibiz.com/item/20578-crowd-control?-social-nature-of-crowdfunding-should-control-fraud-advocates-say.

88. SEC proposed rules, 17 C.F.R § 230, October

30, 2015, http://www.gpo.gov/fdsys/pkg/FR-2015-11-10/pdf/2015-28219.pdf.

89. Securities Exchange Act of 1934 § 12(G) 114, https://www.sec.gov/about/laws/sea34-12g.pdf.

90. Rule 402(b)(1).

91. Ironically, investor protection was likely at the heart of the proposed rule against curation. But it seems the funding portals as intermediaries are, in fact, in the best position to provide guidance to investors through the selection of offerings.

92. Securities Act of 1933 § 4A(f)(3).

93. For example, in his congressional testimony, Sherwood Neiss speculated that a crowdfunding exemption could lead to the development of 500,000 companies and 1.5 million new jobs over a five-year period. Sherwood Neiss, "Crowdfund Investing—A Solution to the Capital Crisis Facing our Nation's Entrepreneurs," Testimony Before the Financial Services Committee, Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, United States House of Representatives, September 15, 2011, p. 10. https://oversight.house.gov/wp-content/uploads/2012/01/9-15-2011_Neiss_TARP_Testimony.pdf.

94. James Williamson has argued in favor of similar funds. James Williamson, "The JOBS Act and Middle-Income Investors: Why It Doesn't Go Far Enough," *Yale Law Journal* 122, 2070–80, http://www.yalelawjournal.org/pdf/1168_gp51jtkg.pdf.

95. "Factors That May Affect Trends in Regulation A Offerings," Government Accountability Office Report to Congressional Committees, July 2012, p. 10, http://www.gao.gov/assets/600/592113.pdf.

96. Ibid., p. ii.

97. To understand the difference, consider a landlord and tenant. The landlord tells the tenant "You may have any pet that is not too destructive. Any animal that lives primarily in a cage is presumptively not destructive." This is like Regulation D. A turtle or hamster will qualify because those pets live primarily in cages. But a well-behaved dog would also qualify. In getting the dog, however, the tenant takes a risk that the landlord will determine that the dog is, in fact, destructive. Getting a hamster carries no such risk.

Consider now that the landlord says instead "As a general rule, you may not have pets. I may, however, identify specific types of pets that will be acceptable for you to have." The landlord then decides that the tenant may have any pet that is fur-covered, has large front teeth, and is tailless. This is like Regulation A. The tenant may have a hamster under this regime, but not a rat, despite the fact that a rat and a hamster are very similar. The rat, however, has a tail and therefore is not permitted no matter how well-behaved it may be.

98. There are many reasons an issuer may abandon a Regulation A submission. The issuer may elect to use Regulation D instead. Its management may be too disorganized to follow through with the process; the issuer may simply fold; or the "issuer" may have been a sham to begin with.

99. Laura Anthony, "Understanding the NSMIA and Navigating State Blue Sky Laws—Part II," *LinkedIn Pulse* (blog) February 3, 2015, https://www.linkedin.com/pulse/understanding-nsmia-navigating-state-blue-sky-laws-ii-anthony-esq-.

100. In addition to the costs merit review imposes on the issuer, there is also a cost to investors. As an example, the Massachusetts state securities board notoriously prevented Massachusetts residents from participating in Apple Computer's IPO in 1980, deeming the company to be "too risky" for investors. For a brief description see Paul Atkins, "Great Moments in Financial Regulation," *Wall Street Journal*, April 28, 2010, http://www.wsj.com/articles/SB10001424052748704471204575210624014568114.

101. Benjamin Miller, "The Truth about Investing through Equity Crowdfunding as an Unaccredited

Investor," *Fundrise* (blog), August, 26 2014, https://fundrise.com/education/blog-posts/the-truth-about-investing-through-equity-crowdfunding-as-an-unaccredited-in.

102. Fundrise Real Estate Investment Trust LLC, "Offering Circular," submitted to the SEC November 25, 2015, https://www.sec.gov/Archives/edgar/data/1645583/000114420415068128/v425704_253g2.htm.

103. Patrick Healy, "On Broadway, Investors with Shallow Pockets," *New York Times*, http://www.nytimes.com/2012/04/19/theater/for-godspell-on-broadway-crowd-sourced-producers.html?_r=0.

104. Ken Davenport, "If Only They Had This When I Crowdfunded *Godspell*," *The Producers Perspective* (blog), https://www.theproducersperspective.com/my_weblog/2015/03/if-only-they-had-this-when-i-crowdfunded-godspell.html.

105. Amendments, 80 Fed. Reg. at 21,899 (to be codified at 17 C.F.R. § 230.256).

106. William Beatty, "Comments in Response to Release Nos. 33-9497; 34-71120; 39-2493; File No. S7-11-13," North American Securities Administrators Association, http://www.sec.gov/comments/s7-11-13/s71113-144.pdf.

107. Jumpstart Our Business Startups Act of 2012, H.R. 3606, 112th Cong. (2012), subtitle.

108. JOBS Act § 402.

109. Government Accountability Office, "Factors that May Affect Trends in Regulation A Offerings," Report 12-839, July 3, 2012, pp. 17–20, http://www.gao.gov/assets/600/592113.pdf.

110. States would still, of course, still be able to bring enforcement actions for fraud and other relevant violations.

111. Companies engaged exclusively in intrastate commerce and whose securities are sold exclusively intrastate are not subject to this provision. They would, of course, be subject to applicable state securities laws and regulations.

112. This mission statement is available on the SEC website. Securities and Exchange Commission, "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation," http://www.sec.gov/about/whatwedo.shtml.

113. United States Department of Labor, Bureau of Labor Statistics, "Entrepreneurship and the U.S. Economy: Chart 3, Survival Rates of Establishments, by Year Started and Number of Years Since Starting, 1994–2010," May 7, 2014, http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm.

RELATED PUBLICATIONS FROM THE CATO INSTITUTE

How Important Are Banks for Development? National Banks in the United States, 1870–1900 by Scott L. Fulford, Cato Institute Research Briefs in Economic Policy no. 44 (February 3, 2016)

Requiem for QE by Daniel L. Thornton, Cato Institute Policy Analysis no. 783 (November 17, 2015)

In Defense of Derivatives: From Beer to the Financial Crisis by Bruce Tuckman, Cato Institute Policy Analysis no. 781 (September 29, 2015)

On the Desirability of Nominal GDP Targeting by Julio Garín, Robert Lester, and Eric Sims, Cato Institute Working Paper no. 32 (August 12, 2015)

The Supply of Transaction Assets, Nominal Income, and Monetary Policy Transmission by Joshua R. Hendrickson and David Beckworth, Cato Institute Working Paper no. 31 (June 23, 2015)

Investment Banks as Corporate Monitors in the Early 20th Century United States by Carola Frydman and Eric Hilt, Cato Institute Research Briefs in Economic Policy no. 27 (June 3, 2015)

International Developments in the Insurance Sector: The Road to Financial Instability? by Therese M. Vaughan and Mark A. Calabria, Cato Institute Working Paper no. 30 (May 27, 2015)

The Limits of Model-Based Regulation by Rainer Haselmann and Vikrant Vig, Cato Institute Research Briefs in Economic Policy no. 25 (April 29, 2015)

Competition and Bank Opacity by Liangliang Jiang, Ross Levine, and Chen Lin, Cato Institute Research Briefs in Economic Policy no. 24 (April 15, 2015)

Beyond Regulation: A Cooperative Approach to High-Frequency Trading and Financial Market Monitoring by Holly A. Bell, Cato Institute Policy Analysis no. 771 (April 8, 2015)

Fatalistically Flawed: A Review Essay on Fragile by Design by Charles W. Calamoris and Stephen H. Haber by George Selgin, Cato Institute Working Paper no. 28 (March 19, 2015)

A Roadmap to Monetary Policy Reforms by Norbert Michel, Cato Institute Working Paper no. 27 (March 18, 2015)

How Are Small Banks Faring under Dodd-Frank? by Hester Peirce, Ian Robinson, and Thomas Stratmann, Cato Institute Research Briefs in Economic Policy no. 20 (February 18, 2015)

The Conservatorships of Fannie Mae and Freddie Mac: Actions Violate HERA and

Established Insolvency Principles by Michael Krimminger and Mark A. Calabria, Cato Institute Working Paper no. 26 (February 9, 2015)

The Resolution of Systematically Important Financial Institutions: Lessons from Fannie and Freddie by Mark A. Calabria, Cato Institute Working Paper no. 25 (January 13, 2015)

The Role of Mortgage Finance in Financial (In)Stability by Mark A. Calabria, Cato Institute Working Paper no. 23 (September 12, 2014)

Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve by Kevin Dowd, Cato Institute Policy Analysis no. 754 (September 3, 2014)

The Paths to Mortgage Finance Reform and Their Budgetary Implications by Ike Brannon and Mark A. Calabria, Cato Institute Working Paper no. 18 (March 18, 2014)

Mortgage Reform under the Dodd-Frank Act by Mark A. Calabria, Cato Institute Working Paper no. 15 (January 27, 2014)

RECENT STUDIES IN THE CATO INSTITUTE POLICY ANALYSIS SERIES

789. **Menu Mandates and Obesity: A Futile Effort** by Aaron Yelowitz (April 13, 2016)

788. **Japan's Security Evolution** by Jennifer Lind (February 25, 2016)

787. **Reign of *Terroir*: How to Resist Europe's Efforts to Control Common Food Names as Geographical Indications** by K. William Watson (February 16, 2016)

786. **Technologies Converge and Power Diffuses: The Evolution of Small, Smart, and Cheap Weapons** by T. X. Hammes (January 27, 2016)

785. **Taking Credit for Education: How to Fund Education Savings Accounts through Tax Credits** by Jason Bedrick, Jonathan Butcher, and Clint Bolick (January 20, 2016)

784. **The Costs and Consequences of Gun Control** by David B. Kopel (December 1, 2015)

783. **Requiem for QE** by Daniel L. Thornton (November 17, 2015)

782. **Watching the Watchmen: Best Practices for Police Body Cameras** by Matthew Feeney (October 27, 2015)

781. **In Defense of Derivatives: From Beer to the Financial Crisis** by Bruce Tuckman (September 29, 2015)

780. **Patent Rights and Imported Goods** by Daniel R. Pearson (September 15, 2015)

779. **The Work versus Welfare Trade-off: Europe** by Michael Tanner and Charles Hughes (August 24, 2015)

778. **Islam and the Spread of Individual Freedoms: The Case of Morocco** by Ahmed Benchemsi (August 20, 2015)

777. **Why the Federal Government Fails** by Chris Edwards (July 27, 2015)

776. **Capitalism's Assault on the Indian Caste System: How Economic Liberalization Spawned Low-caste Dalit Millionaires** by Swaminathan S. Anklesaria Aiyar (July 21, 2015)

775. **Checking E-Verify: The Costs and Consequences of a National Worker Screening Mandate** by Alex Nowrasteh and Jim Harper (July 7, 2015)

774. **Designer Drugs: A New, Futile Front in the War on Illegal Drugs** by Ted Galen Carpenter (May 27, 2015)

773. **The Pros and Cons of a Guaranteed National Income** by Michael Tanner (May 12, 2015)

772. **Rails and Reauthorization: The Inequity of Federal Transit Funding** by Randal O'Toole and Michelangelo Landgrave (April 21, 2015)

771. **Beyond Regulation: A Cooperative Approach to High-Frequency Trading and Financial Market Monitoring** by Holly A. Bell (April 8, 2015)

770. **Friends Like These: Why Petrostates Make Bad Allies** by Emma M. Ashford (March 31, 2015)

769. **Expanding Trade in Medical Care through Telemedicine** by Simon Lester (March 24, 2015)

768. **Toward Free Trade in Sugar** by Daniel R. Pearson (February 11, 2015)

767. **Is Ridesharing Safe?** by Matthew Feeney (January 27, 2015)

766. **The Illusion of Chaos: Why Ungoverned Spaces Aren't Ungoverned, and Why That Matters** by Jennifer Keister (December 9, 2014)

765. **An Innovative Approach to Land Registration in the Developing World: Using Technology to Bypass the Bureaucracy** by Peter F. Schaefer and Clayton Schaefer (December 3, 2014)

Published by the Cato Institute, Policy Analysis is a regular series evaluating government policies and offering proposals for reform. Nothing in Policy Analysis should be construed as necessarily reflecting the views of the Cato Institute or as an attempt to aid or hinder the passage of any bill before Congress. Contact the Cato Institute for reprint permission. All policy studies can be viewed online at www.cato.org. Additional printed copies of Cato Institute Policy Analysis are $6.00 each ($3.00 each for five or more). To order, please email catostore@cato.org.