

**Written Remarks of
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For a “Panel Discussion Regarding Exempt Offerings under Regulation D Rule 506”
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Introduction

Thank you for the opportunity to participate in the committee’s discussion of exempt offerings under Regulation D Rule 506. As the Senior Director of Financial Regulation at the Center for American Progress, I am responsible for policy spanning capital markets and financial institutions regulation. I am an attorney but, importantly, my position is embedded in the Inclusive Economy department of our organization, where we study the broader economy, correlation of risks, and the participation of all Americans. My analysis goes beyond efficient functioning of the capital markets and the protection of investors to the stability of the financial system, the health of the economy, and the public interest.

Prior to my current position, I spent decades in tax policy, including at CAP and earlier as tax counsel to a member of the U.S. Senate Finance Committee. The trajectory of the capital markets from the 1980s forward is closely aligned with the erosion of the federal tax system as it applies to high income taxpayers. Both the tax code and securities regulation over the period have been shaped by an incomplete understanding of the drivers of economic growth, innovation, efficiency, and fairness.

These much broader issues are not what we are here to discuss today, but it is not possible to consider the way forward on Reg D Rule 506 without seeing it in context and acknowledging how we arrived at this point. So I will provide a summary of what I believe is the relevant context before offering recommendations for reform that are informed by it. Nor is it possible to solve the problems with Reg D without accompanying regulatory changes to related aspects of securities law and regulation, which I will elaborate on below.

Purpose of the Federal Securities Laws, and the Rise of the Exceptions

While still in the depths of the Great Depression, Congress enacted the federal securities laws to require full and fair disclosure to the public. A direct consequence of that was that companies and funds selling securities to the public were instantly more transparent and accountable not just to their investors but also to their business partners and the government. This accountability framework succeeded remarkably well for decades and contributed to the growth and success of America’s capital markets.

The exemptions from this framework were very narrowly construed, and even offerings that were deemed to be sufficiently “private” to not be covered were still dependent upon investors receiving the same type of information that they might get from a public offering.¹

That fundamentally changed during the Reagan Administration, as Congress and the SEC began creating new exemptions, including Regulation D. Ironically, just as computers were beginning to empower investors with the ability to gather and quickly analyze more information than ever before, the government was making it easier for companies and funds to sell securities to a seemingly ever-expanding pool of investors without the hallmark disclosures of the securities laws. The standard long upheld by courts that private markets investors receive essential information was almost entirely abandoned.

Today, the opaque private capital markets, where securities offerings are often sold and traded with little or no reliable information, are so vast that more capital is raised there each year than in the public capital markets. Unsurprisingly, this has led to an enormous growth of so-called unicorns, start-up businesses whose private market values have grown to \$1 billion or more—in some cases, much more. In fact, seven private US-based “startups” were purportedly valued at over \$20 billion in July 2023.²

Investors in these private companies may get some information about the companies’ holdings, operations, financials, business prospects, and governance—or they may not. The information that they receive may not be complete or accurate. It might also be different from what other investors may get, often creating significant information asymmetries between not just the issuer and an investor, but between the issuer, its executives, its different investors, and its creditors and business partners. They might all have different information. Investors might also all have different rights.

Importantly, the securities laws are not just about fraud and investor protection; but rather making capitalism work to channel investors’ capital into its best uses. When passing the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress was acutely focused on disclosure as a necessary precondition to avoiding massive “misdirection of capital resources” and economic waste.³ Of course, that objective protects investors from fraud, but it is

¹ See, *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126-127 (1953) (“But once it is seen that the-exemption question turns on the knowledge of the offerees, the issuer’s motives, laudable though they may be, fade into irrelevance. ... The employees here were not shown to have access to the kind of information which registration would disclose.”). Notably, the syllabus of the decision prepared by the Supreme Court reporter explained “In view of the broadly remedial purposes of the Act, it is reasonable to place on an issuer who pleads the § 4 (1) exemption the burden of proving that the purchasers had access to the kind of information which registration under the Act would disclose.” *Id.*, at 119.

² The Complete List of Unicorn Companies, CB Insights, available at <https://www.cbinsights.com/research-unicorn-companies> (last viewed Sept. 11, 2023).

³ See, e.g., H.R. Rep. No. 84, 73d Cong., 1st. Sess. (1933) (describing “irresponsible selling of securities,” and providing that “[w]hatever may be the full catalogue of the forces that brought to pass the present depression, not least among these has been this wanton misdirection of the capital resources of the Nation”); H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934) (“Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value.”); accord, *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), available at <https://supreme.justia.com/cases/federal/us/346/119/#T10> (“the design of the statute

also essential for the evaluation of risk and the efficient allocation of capital among competing uses. It is essential to avoid “the wanton misdirection of the capital resources of the Nation.”⁴

In approaching today’s discussion, it is important to remember that robust and reliable information—transparency—has helped our capital markets become the largest and most liquid in the world. Information is fundamental to a capital economy. And I think we would all agree that unreliable information, partial information, inconsistent information, or information that is presented in a manner that is not timely or comparable to other information degrades confidence in and operation of financial markets.

Unfortunately, amidst heavy lobbying, regulators and Congress have continued creating and expanding loopholes to “ease” “capital formation” for businesses, and purportedly improve access to startup companies for “retail” investors.⁵ But, it is not at all clear that those efforts have resulted overall in a measurable increase in gross domestic product or significant job creation.

However, those efforts have led to private markets swamping the public markets in size – largely unchecked by regulators and inadequately constrained by the business judgment and negotiating powers of investors. Operational companies and funds looking to sell securities to investors may prefer operating in the private markets, where they can increasingly access all the capital they need but maintain the ability to discriminate against some investors and counterparties, avoid regulators, avoid public market liability, and avoid making the types of disclosures that would allow more rigorous evaluation of their economic worth and prospects.⁶

There is no question that private securities offerings and valuations began to soar after Reg D and other exceptions were implemented.⁷ And, not surprisingly, owners of highly-valued private securities wanted to turn those stakes into cash. Historically, there were few places to trade such securities, and few investors able to purchase them. Private securities (particularly debt securities) were bought and held for many years. But today they are often traded on various loosely regulated trading platforms. These options are still limited to sophisticated institutions

is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.”) (citing *A. C. Frost & Co. v. Coeur D’Alene Mines Corp.*, 312 U.S. 38, 40 (1941).

⁴ H.R. Rep. No. 84, 73d Cong., 1st. Sess. (1933).

⁵ See, generally, Remarks of Hester Peirce before the Fordham Journal of Corporate and Financial Law Conference, Oct. 22, 2021, available at <https://www.sec.gov/news/speech/peirce-remarks-fordham-journal-102221>; see also, Jennifer J. Schulp, *IPOs, SPACs, and Direct Listings, Oh My!*, CATO Institute, May 21, 2021, available at <https://www.cato.org/commentary/ipos-spacs-direct-listings-oh> (last visited Sept. 8, 2023).

⁶ Jessica E. Vascellaro, “Facebook CEO in No Rush To ‘Friend’ Wall Street,” *The Wall Street Journal*, March 3, 2010, available at <https://www.wsj.com/articles/SB10001424052748703787304575075942803630712>.

⁷ See, e.g., Elisabeth de Fontenay, “The Deregulation of Private Capital and the Decline of the Public Company,” *Hastings L. J.*, 2017, available at https://scholarship.law.duke.edu/faculty_scholarship/3741/; and George S. Georgiev, “The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms,” *Emory U. Sch. of Law*, Fall 2021, available at <https://scholarlycommons.law.emory.edu/faculty-articles/2/>.

and wealthier individuals, so executives and private investors turn to the public markets through approaches that minimize investor and public scrutiny.

Thus, while companies generally no longer come to the US public markets to raise the capital they need to grow their business, they often do come to the public markets to allow their early investors and founders to cash out.

In recent years, Special Purpose Acquisition Companies (SPACs), shell public companies that later acquire a private company, rose in popularity in part as a way to go public while minimizing disclosure of information and the time needed to scrutinize it. Direct listings and even traditional IPOs making use of the “confidential” filing process may also accomplish this. Hundreds of private companies with limited disclosures have become public reporting companies through these methods, and the results in many cases have been catastrophic for investors – wasting tens of billions of dollars of precious investor capital. While one might argue this is the nature of investing, Congress never intended these companies’ shares to be available to the public without full disclosure and sufficient time to analyze all relevant information.

For many decades, newly public companies have materially underperformed the broader public markets.⁸ In recent years, as the private markets (and the valuations of many private firms) have skyrocketed, that performance gap has grown. For example, a Goldman Sachs analysis found (contrary to its business model of working as an underwriter), that for the period 2010 through 2020, the median IPO underperformed the broader Russell 3000 by a stunning 28 percent after three years.⁹ Since 2020, the markets have been even more chaotic. The majority of IPOs have been SPACs. And for the SPACs that have found targets and completed their mergers, they are averaging declines of 80 percent or more in value, and many are going bankrupt.¹⁰ Many non-SPAC IPOs have not performed much better.¹¹

While this might be considered “capital formation” for the executives and connected investors, many of whom may have offloaded their private securities onto the public markets at inflated valuations, that is not capital that is helping our economy. The resulting transfer of wealth may

⁸ See, e.g., Edward Miller, “Long run underperformance of initial public offerings: an explanation;” *Department of Economics and Finance Working Papers*, 1991-2006, Paper 16 (2000), available at https://scholarworks.uno.edu/econ_wp/16.

⁹ Charis Mathews, “Investors beware: The typical IPO stock is a dud, says Goldman Sachs,” *MarketWatch*, Sept. 5, 2019, available at <https://www.marketwatch.com/story/investors-beware-the-typical-ipo-stock-is-a-dud-says-goldman-sachs-2019-09-05>.

¹⁰ Amrith Ramkumar, “SPACs Delivered Easy Money, but Now Companies Are Running Out,” *The Wall Street Journal*, April 26, 2023, available at <https://www.wsj.com/articles/spacs-delivered-easy-money-but-now-companies-are-running-out-f086c255> (noting the bankruptcy of Virgin Orbit despite its SPAC merger, and noting over 100 of the 342 companies that had undertaken a SPAC merger for the period 2016 through 2022 that had recently made SEC filings were running dangerously low on cash).

¹¹ See, e.g., Ananya Bhattacharya, “When it comes to IPOs, 2022 was nothing like 2021,” *Quartz*, December 2, 2022, available at <https://qz.com/when-it-comes-to-ipos-2022-was-nothing-like-2021-1849845203>.

enable a Silicon Valley executive to buy a hundred million dollar house, but it isn't likely to create jobs.¹²

When a broad swath of American investors sink billions of dollars into private unicorns that perform poorly or fail, that is billions of dollars that are not going to more productive uses, such as the investments needed for the transition to a clean economy and to prepare for future pandemics. That is precisely the misdirection of capital that Congress was seeking to protect our country from nearly a century ago.

This situation is exacerbated significantly because the so-called "private" market exemptions are not tailored to help just small companies raise capital. Rather, the most commonly used exemptions have no size limit. What this often means is that hundreds of millions or billions of dollars are often poured into late-stage funding rounds of very large private companies, instead of perhaps better long-term investment prospects at companies run by people seeking to create resilient businesses that will be consistently profitable and will provide value to shareholders and customers as the economy changes.

By diverting so much capital to companies without the benefits of full and fair information and accountability, the exemptions are now hurting the small businesses they were purportedly intended to help.¹³ For example, the \$95 million dollars that the Ontario Teachers Pension Plan invested in FTX was written down to zero less than a year after the investment.¹⁴ The teachers' pension didn't just lose the \$95 million that was lit on fire propping up a fraud, but rather the returns those dollars could have generated, if invested elsewhere. And – equally important – other would-be target companies were deprived of \$95 million in precious capital that would have almost certainly been put to better use. The lost economic productivity created by private market exceptions is almost surely staggering.

A hallmark of the private markets is that, for most of the exemptions, the entirety of the investment experience is governed by private contractual negotiations and not existing market regulation. While the securities laws generally prevent fraud and promote efficient capital allocation, the information available to investors and other parties, the rights of investors and other parties, the responsibilities, and availability of investor recourse for failures are all

¹² See, e.g., Katherine Clark and E.B. Solomont, *Crypto CEO Brian Armstrong Buys Los Angeles Home for \$133 Million*, Wall St. J., Jan. 3, 2022, available at <https://www.wsj.com/articles/crypto-ceo-brian-armstrong-buys-los-angeles-home-for-133-million-11641249787>; and Michelle Chapman, *Another round of Coinbase job cuts, 20% of workforce let go*, Associated Press, Jan. 10, 2023, available at <https://apnews.com/article/cryptocurrency-technology-business-89fecc513188b68edeb172a5d85e3b39> (reflecting multiple rounds of Coinbase layoffs beginning in 2022).

¹³ See, Remarks of Caroline Crenshaw before the Securities Regulation Institute, Jan. 30, 2023, available at https://www.sec.gov/news/speech/crenshaw-remarks-securities-regulation-institute-013023#_ftnref28; see also, "In the Public Interest: Why Policymakers and Regulators Must Restore the Public Capital Markets," Healthy Markets Association, January 2022, available at <https://healthymarkets.org/product/public-vs-private-markets-a-special-report>.

¹⁴ Bloomberg, "Ontario Teachers marks down \$95 million in vestment in FTX to zero," Pensions & Investments, November 18, 2022, available at <https://www.pionline.com/pension-funds/ontario-teachers-marks-down-95-million-investment-ftx-zero#:~:text=Ontario%20Teachers'%20Pension%20Plan%20said,Fried's%20now%20bankrupt%20cryptocurrency%20exchange>.

essentially up for grabs. Caveat emptor replaces exchange between well informed counterparties.

In the world of private markets, two predictable themes have emerged: (1) investors do not have sufficient information to make well-informed decisions, and (2) discrimination and preferential treatment appear to be commonplace. Again, this is a concern given that private markets now effectively have ready access to public funds, and an increasing number of very large private companies are drawing their funding from a broad swath of the American public.

Investors Frequently Lack Sufficient Information with Which to Make Informed Investment Decisions

Contrary to the federal securities' laws explicitly stated purpose, the SEC has adopted a slew of rules, including Rule 506, that do not require companies to provide specific information to investors about their operations, finances, or governance, much less about their climate risks or anything else.

The justification for limiting required disclosures was that investors in the private markets – which have historically had wealth or income – “didn’t need” the protection of the securities laws. That theory is easily controverted by the facts – both recent and historical. Whether we are talking about the securitization products of the early 2000s that gave rise to the Global Financial Crisis,¹⁵ or the collapses of so many technology and financial firms over the past few years, the losses impacted far more than simply the investors, but the economy at large.

Returning to my earlier example, in October 2021 and again in January 2022, the Ontario Teachers Pension Plan invested a collective \$95 million in a wildly popular digital asset exchange.¹⁶ The pension and some of the other most sophisticated private markets investors in the world invested \$2 billion dollars in a company that did not have a Chief Financial Officer and had only a semblance of corporate governance controls or meaningful financial controls.¹⁷ If these investors had known that expenses and investments were often undocumented or that the CEO had bought a \$16 million house in the Bahamas used by his parents, would they have driven the valuation to \$32 billion just months before the company would collapse into bankruptcy?¹⁸ What if, years earlier, the company had been subjected to audits and had to disclose financials prepared pursuant to Generally Accepted Accounting Principles?

¹⁵ Many of the assets underpinning the Global Financial Crisis, such as collateralized debt obligations (CDOs) were private market assets. See, “Wall Street and the Financial Crisis: Anatomy of a Financial Collapse,” Permanent Subcommittee on Investigations, at 323 (2011), available at [https://www.hsgac.senate.gov/wp-content/uploads/imo/media/doc/PSI%20REPORT%20-%20Wall%20Street%20&%20the%20Financial%20Crisis-Anatomy%20of%20a%20Financial%20Collapse%20\(FINAL%205-10-11\).pdf](https://www.hsgac.senate.gov/wp-content/uploads/imo/media/doc/PSI%20REPORT%20-%20Wall%20Street%20&%20the%20Financial%20Crisis-Anatomy%20of%20a%20Financial%20Collapse%20(FINAL%205-10-11).pdf).

¹⁶ The Canadian Press, “Ontario Teachers’ Pension Plan Invested US\$95M into failing crypto platform FTX,” November 10, 2022, available at <https://globalnews.ca/news/9270229/ontario-teachers-pension-plan-fts-trading/>.

¹⁷ Ontario Teachers’ statement on FTX, November 17, 2022, available at <https://www.otpp.com/en-ca/about-us/news-and-insights/2022/ontario-teachers--statement-on-ftx/>.

¹⁸ Jamie Crawley, “FTX Reaches \$32B Valuation With \$400M Fundraise,” CoinDesk, January 31, 2022, available at <https://www.coindesk.com/business/2022/01/31/ftx-reaches-32b-valuation-with-400m->

Sarbanes-Oxley was passed following large-scale accounting scandals in public companies. It dramatically improved the reliability of financials of public companies. Unfortunately, the increased integrity and reliability of disclosures in the public markets is not mandated in private markets. This asymmetry is a likely contributor to the accounting and financial scandals among increasingly large private companies, like FTX, Theranos, and Nikola.¹⁹

The lesson is simple: the alleged frauds took place in markets where basic disclosures were not made. Executive decisions were not sufficiently challenged by auditors. Lies could not be readily tested. Application of SOX rules would have made this less likely.

One of the most important elements of any investment is its value. Valuations are often a function of a company's assets, operations, governance, and prospects. But without detailed, comparable, reliable, and consistent information about those factors, how can investors assign values?

In the public markets, valuations are relatively easy to see. Stock prices on registered securities exchanges move up and down every day, and the public can see what others are willing to pay to buy or sell the securities. Those prices, in turn, are typically functions of supply and demand dynamics, as informed by regulatorily-mandated filings (such as 8-Ks and 10-Ks), world events, and other factors. They tend to be volatile – in both directions.

But the prices of private markets securities are generally not readily ascertainable by looking at prices in transparent trading venues. Further, private companies are not generally required by SEC rules to announce to everyone that their biggest customer left, or their lead engineer quit, or their clinical trial is looking bad. If the private securities are themselves interests in funds, the issuers generally are not required by SEC rules to disclose issues that may be impacting their other holdings.

The lack of mandatory disclosures can result in valuations for private companies or funds that have little to no resemblance to the prices that those securities would fetch in the public markets at any particular moment.

For startup companies or venture funds, valuations are often simply functions of the most recent funding round, regardless of how much was purchased, how many investors invested, or whether there were any subsequent intervening events. For example, if two affiliated investors decided to buy 5 percent of a company through investing \$5 million, the purported valuation of the company could be reported as \$100 million on the fifth-grade logic that, if five percent of shares are worth \$5 million, then the whole company must be worth \$100 million. But what if

[fundraise/#:~:text=FTX%20raised%20%24400%20million%20in,the%20Nasdaq%20exchange%20or%20Twitter..](#)

¹⁹ See, e.g., Press Release, "SEC Charges Samuel Bankman-Fried with Defrauding Investors in Crypto Asset Trading Platform FTX," U.S. Securities and Exchange Commission, December 13, 2022, available at <https://www.sec.gov/news/press-release/2022-219>; Press Release, "Theranos, CEO Holmes, and Former President Balwani Charged With Massive Fraud," U.S. Securities and Exchange Commission, March 14, 2018, available at <https://www.sec.gov/news/press-release/2018-41>; and Press Release, "Nikola Corporation to Pay \$125 Million to Resolve Fraud Charges," U.S. Securities and Exchange Commission, December 21, 2021, available at <https://www.sec.gov/news/press-release/2021-267>.

those shares were purchased two years ago and since then all of the company's customers have left?

For private equity funded firms, the valuations are often based on comparisons to similarly-situated public companies or holdings. But there is no requirement that those comparisons be disclosed or that their applicability be justified. And if the assets of the publicly traded company used for that comparison decline in value, there is no certainty that the private fund will reflect a similar reduction in the value of its assets.

Unfortunately, private securities sellers, executives of private companies and funds, and investment managers may have significant conflicts of interest that incentivize them to overvalue private market assets precisely because they tend to not reflect drops in their values as quickly as public markets, giving rise to a phenomenon that noted investor Cliff Asness has termed the "illiquidity premium."²⁰

For example, public pension funds might have their holdings and percentage funded status adversely impacted by having their private markets holdings decline when broader public markets values decline. This could give rise to controversial new contribution requirements on beneficiaries, taxes, or political criticisms – none of which are likely good for the employees responsible for managing the fund. Further, timely, accurate valuations of private securities holdings might also negatively impact the funds' overall performance metrics, which might also directly impact executives' personal compensation.

Unfortunately, this does not mean the values of those private securities have not deteriorated. Rather, it simply means that the fair value of the assets is not being recognized.

Discrimination and Preferential Treatment Are Permissible in the Private Markets

In the absence of mandatory, standardized disclosure requirements in the private markets, investors are often left with only such information and rights as they may be able to negotiate (and enforce). That's a concern where a broad swath of the American public is exposed to the private markets.

It is possible for the substance of any information provided to investors to vary significantly vis-a-vis different investors. For example, one investor could receive detailed, monthly financial statements with significant specificity, while another investor might receive essentially no information at all. Some investors (including company executives and venture fund investors) might be alerted to significant changes in the holdings, operations, governance, or prospects of the private company, while others are not.

The timeliness of any information provided to investors could also vary significantly. One sophisticated investor could get monthly reports from a private securities issuer, while another

²⁰ Hannah Zhang, "Cliff Asness Questions Whether Investors in Private Equity Are Being Rewarded—or Penalized—for Taking Illiquidity Risk," Institutional Investor, June 2, 2022, available at <https://www.institutionalinvestor.com/article/2bstolqfnrubgold0lkow/portfolio/cliff-asness-questions-whether-investors-in-private-equity-are-being-rewarded-or-penalized-for-taking-illiquidity-risk>.

who is invested in the same firm might only receive quarterly or annual information, or nothing at all after the initial investment.

Other rights, including board representation, rights of first refusal, approvals for major business changes, or even the rights to redeem investments (and at what terms) could also be readily differentiated between different investors. Some investors may be allowed to withdraw their assets at any time, while others may be compelled to stay in the investment for years (and perhaps risk losing all of its value).

While it would be impossible to develop data on these points without reliable disclosures, the evidence of harms to investors is plenty clear enough. The very fact that the harms happen at all in a market to which so many Americans are exposed calls for broad measures to improve the amount, type, timeliness, and reliability of information disclosures in these markets and strong rules to promote fairness.

Proposed Solutions to Address Specific, Identified Weaknesses in the Current Private Markets Regulatory Regime

The SEC and investors are already extremely familiar with the weaknesses identified above and are considering or have recently adopted significant changes to better protect investors and the economy as a whole.

a. The SEC should make widely held and large companies public reporting companies

How securities are held (and by whom) has changed significantly over the past several decades. For example, while stockholders often used to hold paper stock certificates themselves, they typically now receive electronic confirmations of their ownership of the securities that are held at financial institutions. Also, investors often turn to funds that pool investors' capital to make investments. As a result of these changes, the "holder of record" has generally shifted from individual investors to their intermediaries. Today, a company may have hundreds or even thousands of "beneficial owners," while having only a handful of "holders of record." This is particularly important because the law requires companies with large numbers of holders of record to become public reporting companies.

The SEC should exercise its authority to modernize the definition of "held of record" to reflect the true beneficial owners of securities.²¹ Indeed, the SEC has announced in its regulatory agenda that such a proposal may be forthcoming.²²

²¹ See, Securities Acts Amendments, Public Law 467, 88th Cong., 2nd sess. (August 20, 1964), available at <https://www.govinfo.gov/content/pkg/STATUTE-78/pdf/STATUTE-78-Pg565.pdf>; see also, Exchange Act Amendments, Public Law 94-29, 94th Cong., 1st sess. (June 4, 1975), available at <https://www.congress.gov/94/statute/STATUTE-89/STATUTE-89-Pg97.pdf>.

²² U.S. Securities and Exchange Commission, Agency Rule List – Spring 2023, available at https://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode&showStage=active&agencyCd=3235.

Separately, the SEC should require companies with significant valuations (ideally, well under \$1 billion) or large numbers of employees, or that have significant average annual gross revenues, to become public reporting companies.

b. The SEC should make very large offerings of securities public offerings

While the federal securities laws generally do not define a “public” or “private offering,” the law does allow the SEC to adopt interpretations of those terms so as to protect investors and further the purposes of the law. The current exemption framework unfortunately enables unlimited sums to be raised from an unlimited number of unaffiliated people – that is a public offering, and it should be regulated as such. The threshold, for example, could be around \$100 million.

c. The SEC should combat self-dealing, prevent unfair discrimination, and stop insider trading by requiring information parity among investors

When some investors and insiders have significantly more or more timely information than others, the information asymmetry may give rise to significant waste, fraud, and abuse, particularly through exploitation of under-affiliated and less connected investors.

Over two decades ago, the SEC adopted Regulation FD to explicitly prohibit public securities issuers from selectively sharing information with favored investors.²³ Just last month, however, the SEC acknowledged in its Private Funds Disclosure Rule that many of the same concerns for investors exist in the private markets, as well. In fact, because there is no Regulation FD counterpart currently, issuers of private securities and their executives can provide different information at different times to different investors.²⁴

The SEC’s Private Funds Disclosure Rule would essentially prevent a private fund from selectively disclosing information to favored investors without offering it to all investors, but that rule would not apply to private securities issuers generally. It should.

d. The SEC should combat self-dealing, prevent unfair discrimination, and stop insider trading by requiring parity in redemption rights among investors

While securities in the public markets are generally readily tradable at relatively transparent prices, securities in the private markets generally are not. Investors may contractually commit to not selling their securities to third parties for periods of time or may be entirely prohibited from trading them by the issuer or some other party.

Just last month, however, the SEC acknowledged in its Private Fund Advisers Disclosure Rule the extent of these risks for investors in the private markets.²⁵ As the release for that rule explains:

²³ 17 CFR § 243.100.

²⁴ Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Fed.Reg., Vol.88, No.177, September 14, 2023 at 63206.

²⁵ Id.

Conflicts of interest can harm investors, such as when an adviser grants preferential redemption rights to entice a large investor that will increase overall management fees to commit to a private fund, and then, when the fund experiences a decline, such preferential redemption rights allow a large investor to exit the private fund before and on more advantageous terms than other investors...There is a trend of rising interest in private funds by smaller investors with less bargaining power, who may be particularly impacted by these practices, including where advisers grant preferential terms to larger investors that may exacerbate conflicts of interest as well as the risks of resulting investor harm.²⁶

The SEC's Private Fund Advisers Disclosure Rule would generally prevent a private fund from selectively offering preferential redemption rights to favored investors without offering those terms to all investors. However, that rule would not apply to private securities issuers generally. It should.

e. The SEC should condition all private offerings on companies first providing full, fair, and timely baseline information

As the Supreme Court has explicitly recognized, the purpose of the federal securities laws is to ensure that investors have sufficient information with which to make informed investment decisions.²⁷ As the Center for American Progress stated in its recent report:

Trillions of dollars in retirement fund losses from the 2008 global financial crisis and evidence from state securities regulators' enforcement dockets, which are replete with frauds targeted at seniors and other accredited investors, suggest that all investors, regardless of their level of sophistication, would benefit from the full and fair disclosure mandated by the public disclosure regime.²⁸

The SEC has explicitly recognized this reality in its recent adoption of the Private Funds Disclosure Rule.²⁹ While far less than what it requires for registered investment companies, the SEC has insisted in that rule that private funds and their advisers make basic disclosures to investors, which includes information about relationships between executives and affiliated persons, as well as information about how assets are valued, governance, and more. Much like the SEC's Private Funds Disclosure Rule would require information to be provided on an initial and ongoing basis, these requirements should also be applied to all large private offerings.

²⁶ Id. at 63210.

²⁷ *SEC v. Ralston Purina Co.* at p.124.

²⁸ CAP Report (citing Barbara A. Butrica, Karen E. Smith, and Eric J. Toder, "What the 2008 Stock Market Crash Means for Retirement Security" (Washington: Urban Institute, 2009), p. 2, available at <https://www.urban.org/sites/default/files/publication/30291/411876-What-the-Stock-Market-Crash-Means-for-Retirement-Security.PDF>).

²⁹ See, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, U.S. Securities and Exchange Commission, 88 Fed. Reg. 63206 (Sept. 13, 2023), available at <https://www.govinfo.gov/content/pkg/FR-2023-09-14/pdf/2023-18660.pdf>.

This should start with conditioning any offering in reliance on Regulation D on filing both more detailed pre-offering and post-closing Form Ds.

Further, private issuers should be required to identify, assess, and disclose material risks on an ongoing basis, including risks related to financials, operations, governance, and more, including climate-related physical risks and risks the company faces as a result of the transition to a clean energy economy. Unfortunately, as the North American Securities Administrators Association has explained for many years, the current framework leaves federal and state regulators with inadequate information to identify frauds and material risks.

Failure to comply with these requirements should give rise to liability for both the issuers and their engaged executives. Further, such non-compliance should give rise to rights of rescission for any purchasers.

f. The SEC should improve the reliability of information provided by and finances for larger, still-private offerings by requiring annual disclosure of audited financial statements.

As the courts long recognized after the adoption of the federal securities laws and the SEC has finally highlighted in its recently adopted Private Funds Disclosure Rule,³⁰ there should be a baseline of reliable information provided to investors irrespective of whether or not those offerings are exempt from registration under the Securities Act of 1933. Independent auditors performing audits of financial statements prepared in accordance with Generally Accepted Accounting Principles are intended to do just that.

Virtually all of the financial crises and failures of recent decades have involved some degree of audit failure, including the savings and loan crisis of the late 1980s and early 1990s,³¹ the Enron bankruptcy of 2001,³² the WorldCom scandal,³³ the global financial crisis,³⁴ the recent failures of several very large private firms (including FTX³⁵ and Terraform Labs³⁶), and the recent failures

³⁰ Id.

³¹ Robert A. Rosenblatt, "Auditor Pays \$400 Million for Not Signaling S&L Crisis," Los Angeles Times, November 24, 1992, available at <https://www.latimes.com/archives/la-xpm-1992-11-24-mn-1128-story.html>.

³² Reed Abelson and Jonathan D. Glater, "Enron's Collapse: The Auditors; Who's Keeping the Accountants Accountable?" The New York Times, January 15, 2002, available at <https://www.nytimes.com/2002/01/15/business/enron-s-collapse-the-auditors-who-s-keeping-the-accountants-accountable.html>.

³³ Javiriyah Sshraf, "The accounting fraud at WorldCom: the causes, the characteristics, the consequences, and the lessons learned," University of Central Florida, 2011, available at <https://stars.library.ucf.edu/cgi/viewcontent.cgi?article=2106&context=honorstheses1990-2015>.

³⁴ Jonathan Ford and Madison Marriage, "The Big Flaw: Auditing in Crisis," Financial Times, August 1, 2018, available at <https://www.ft.com/content/29ccd60a-85c8-11e8-a29d-73e3d454535d>.

³⁵ "The Collapse of FTX," Forbes, available at <https://www.forbes.com/sites/forbesstaff/article/the-fall-of-ftx/?sh=1b0ba4a47d0c> (last accessed September 2023).

³⁶ Press Release, *SEC Charges Terraform and CEO Do Kwon with Defrauding Investors in Crypto Schemes*, U.S. Securities and Exchange Commission, Feb. 16, 2023, available at <https://www.sec.gov/news/press-release/2023-32>.

of mid-sized US banks.³⁷ Some of the noncompliance issues in these cases went undetected for years, compounding the ultimate financial fallout for the companies involved.

These events have repeatedly shown that investors' reliance may be misplaced, that even the most egregious legal and regulatory noncompliance with catastrophic implications for the company and ultimately the investment and retirement portfolios of millions of Americans may go unnoticed, unreported, or unaddressed.

g. The SEC should work with Congress to eliminate or materially narrow the “confidential filing” process used by the vast majority of “traditional” IPOs

First enacted by the JOBS Act, the pre-IPO confidential filing process materially diminishes the scrutiny applied by private markets experts to private companies looking to enter the public markets. Historically, the filing of a Form S-1 would be followed by months of scrutiny by investors, research analysts, academics, and other experts (including competitors and business partners) who would have sufficient time to review and analyze the claims. Often, this scrutiny identified risks and concerns for investors that may not have been flagged as problematic by the SEC (or its staff). For example, it was this process that allowed investors to scrutinize claims by the parent of WeWork that led to numerous corporate changes and a dramatic re-evaluation of the firm prior to its shares being made available to the broader public market in 2019.³⁸

However, many would-be public issuers of securities sought to avoid this sometimes lengthy public process and instead wished to have their communications with the SEC staff regarding the adequacy of the registration statement kept secret. Then, after the skids were effectively greased with the regulators, they would then seek to file a public version, which very shortly thereafter would be followed by the IPO itself.

Congress initially established a confidential process for smaller companies, but that process was then expanded for larger ones.³⁹ Now, the majority of companies engaging in “traditional” IPOs use it. Unfortunately, the results have been disastrous. Investors have generally been left with insufficient time to analyze information and fully form opinions, and, because the research process into companies is often iterative (and crowdsourced), material weaknesses in the disclosures or issuers themselves are often not identified or fully appreciated until after they are already public, leading to significant price declines shortly after the IPOs. This process should be abandoned or, at a minimum, limited to only the very smallest public offerings. Further, the period between when the details are public and the IPO takes place should be established by regulation at not less than 30 days.

³⁷ Atul Shah, “US banking failures: the role of big auditors in another financial crisis,” City, University of London, May 31, 2023, available at <https://www.city.ac.uk/news-and-events/news/2023/05/us-banking-failures-the-role-of-big-auditors-in-another-financial-crisis>.

³⁸ See generally, David Trainer, “WeWork is the Most Ridiculous IPO of 2019,” Forbes, August 27, 2019, available at <https://www.forbes.com/sites/greatspeculations/2019/08/27/wework-is-the-most-ridiculous-ipo-of-2019/?sh=3fb301e01ad6>.

³⁹ Press Release, “SEC’s Division of Corporation Finance Expands Popular JOBS Act Benefit to All Companies,” U.S. Securities and Exchange Commission, June 29, 2017, available at <https://www.sec.gov/news/press-release/2017-121>.

h. The SEC should more robustly examine and enforce its anti-fraud provisions against the issuers of private securities, and prohibit mandatory investor arbitration of fraud claims in private market offerings

Now that virtually every investor in America is exposed at some level to the private markets and use of exemptions is growing at an alarming rate, enforcement of anti-fraud statutes against issuers in these markets is arguably more important than in the public markets where information is provided, verified, and made public. Fraud can happen anywhere but exempting large issuers and frankly any issuer from even the most basic disclosures is a license to cheat. Many may not, but there will always be those who do. That does not facilitate efficient allocation of capital or protect investors.

Mandatory arbitration is not allowed in the public marketplace because of the significant power differential between investors and issuers. That power differential is even greater in the private markets where issuers hold all of the information about operations, management, financials, and risk, without any meaningful requirement of disclosing that information, even to truly sophisticated investors.

i. The Rule 701 exemption should be dramatically restricted

The seminal Supreme Court case outlining the private markets rules, *SEC v. Ralston Purina Co.*, declared that an offering to employees was a public offering because (1) “[t]he employees ... were not shown to have access to the kind of information which registration would disclose” and (2) “[t]he obvious opportunities for pressure and imposition [due to the employee relationship] make it advisable that they be entitled to” the protections afforded by the federal securities laws’ registration requirement.⁴⁰ The Court also noted that Congress had considered an exemption for employee stock plans during the original consideration of the securities laws, and rejected it.⁴¹

Since then, Congress and the SEC have reversed course and created and expanded exemptions. However, the lack of information and the opportunities for “pressure and imposition” on employees – particularly to coerce employees into accepting risky (or low value) securities in lieu of compensation – are far greater than they were then. The Commission should work with Congress to revise and more narrowly tailor the exemption or eliminate it altogether.

Conclusion

It is not histrionic to say that the capital markets are heading for a fall. Reg D is both a symptom and a cause of the underlying problem—abandonment of the lessons learned around the Great Crash so long ago. Times have changed and so have the economy, technology, and so much more. But human nature has not. Nor has the basic idea that two parties possessed of full and fair information will transact efficiently and effectively. Congress created the SEC to manage the disclosure framework over time, to navigate these changes for the protection of investors, fair

⁴⁰ *SEC v. Ralston Purina Co.*, at 125-127.

⁴¹ *Id.* at 126.

and efficient markets, and efficient capital formation. And, I might add, to make course corrections.

The cat is out of the bag. Private market issuers are not only selling to the public, they are growing huge, employing thousands, and selling products and services to millions of people. The SEC has a duty to ensure that investors and whoever represents them have reliable, consistent, comparable, and full information needed to make sound investment decisions. There are many options to move in that direction, from narrow to bold, some of which I have mentioned today. I strongly encourage this committee to make robust recommendations to the commissioners, imploring them to act boldly before the next crisis happens.