

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

September 6, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: September 11, 2019 Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing Entitled: “Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment”

On Wednesday, September 11, 2019 at 10:00 a.m., the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment.” Witnesses for the hearing are:

- **Renee Jones**, Associate Dean for Academic Affairs and Professor of Law, Boston College Law School
- **Elisabeth de Fontenay**, Professor of Law, Duke University School of Law
- **Mike Pieciak**, President, North American Securities Administrators Association, and Vermont Commissioner of Financial Regulation, Vermont Department of Financial Regulation
- **Dr. Andrew Lo**, Professor, Massachusetts Institute of Technology Sloan School of Management
- **Douglas Ellenoff**, Partner, Ellenoff Grossman & Schole LLP

Witnesses may be added to the list prior to the hearing.

Background

The Securities Act of 1933 (“Securities Act”) requires the disclosure of all material facts about securities that are publicly offered for sale, so that investors can make fully informed investment and voting decisions.¹ Section 5 of the Securities Act requires every offer and sale of securities to be registered with the Securities and Exchange Commission (SEC), unless there is an exemption available.² For registered securities, issuers are required to file a registration statement with the SEC, which includes a prospectus containing audited financial statements, as well as detailed disclosures about the issuer’s business operations, financial condition, risk factors, and its management.³

¹ See H.R. REP. NO. 73-85, at 1 (1933) (stating that the purpose of the Act was “to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails”).

² 15 U.S.C. § 77e.

³ See generally SEC, FORM S-1, available at <https://www.sec.gov/about/forms/forms-1.pdf>.

The Securities Act provides a number of exemptions from the registration requirements,⁴ and authorizes the SEC to exempt additional classes of securities.⁵ A security offered or sold in reliance on an exemption is known as an “exempt offering” and the markets for these exempt offerings are known as “private markets.” Because exempt offerings are not required to be registered, investors receive significantly less information about the security than investors in registered offerings. Generally, exempt offerings are limited to sophisticated investors who are judged not to need the protections of the securities laws.⁶ Public companies can issue both registered offerings and certain exempt offerings, while private companies may only issue exempt offerings.⁷

The Growth of Private Markets

The private markets have grown significantly in recent years and are now more than double the size of the public markets: in 2018, issuers raised roughly \$2.9 trillion of capital through exempt offerings, compared to only \$1.4 trillion through public offerings.⁸ Changes to the securities laws over the years have made it significantly easier for companies to remain private longer and raise capital through the private markets. For example, in 1990 the SEC adopted Rule 144A which facilitated a new type of exempt offering by relaxing restrictions on the resale of certain private securities.⁹ The National Securities Markets Improvement Act of 1996 made it more attractive for companies to issue private securities under Rule 506 by preempting state securities registration requirements.¹⁰ Finally, the Jumpstart Our Business Startups Act of 2012 (JOBS Act) increased the number of record shareholders that a company can have before becoming a public company and triggering the public reporting requirements from 500 to either: (1) 2,000 total shareholders; or (2) 500 shareholders who are non-accredited investors.¹¹ In addition, the JOBS Act (1) created a new exempt offering that allows issuers to use general solicitation,¹² (2) increased the amount that issuers are allowed to raise under Regulation A,¹³ and (3) created a new exempt offering for “crowdfunding” offerings.¹⁴

In June 2019, the SEC issued a concept release to solicit comments on ways to harmonize the current exempt offering framework.¹⁵ Specifically, the SEC sought comments on ways to make it easier for issuers (especially smaller issuers) to raise capital in the private markets.¹⁶

⁴ See generally Section 3 of the Securities Act of 1933 [15 U.S.C. § 77c].

⁵ See Section 28 of the Securities Act of 1933 [15 U.S.C. § 77z-3] (authorizing the SEC to exempt “any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”).

⁶ See generally SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. 30460, 30462–30463 (June 26, 2019).

⁷ Companies that are subject to the reporting requirements of section 13 or section 15(d) of the Securities Exchange Act of 1934 are considered “public companies.” This memo refers to companies that are *not* subject to those reporting requirements as “private companies.”

⁸ SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. at 30465.

⁹ See SEC, RESALE OF RESTRICTED SECURITIES; CHANGES TO METHOD OF DETERMINING HOLDING PERIOD OF RESTRICTED SECURITIES UNDER RULES 144 AND 145: FINAL RULE, 55 Fed. Reg. 17933 (April 30, 1990).

¹⁰ See Public Law 104-290, at § 102 (1996).

¹¹ See Public Law 112-106, at Title V (2012).

¹² *Id.* at Title II.

¹³ *Id.* at Title IV.

¹⁴ *Id.* at Title III.

¹⁵ SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. 30460.

¹⁶ *Id.* at 30461 (stating that “we seek to identify gaps in our framework that may make it difficult, especially for smaller issuers, to rely on an exemption from registration to raise capital at key stages of their business cycle.”).

Types of Exempt Offerings

There are several different types of exempt offerings; this section will focus on the most common exempt offerings (for a full list, see the appendix). Exempt offerings are subject to a variety of different restrictions, such as limits on the types of investors, limits on the size of the offering, and/or restrictions on the resale of the securities.

Rule 506 of Regulation D

Section 4(a)(2) of the Securities Act exempts “transactions by an issuer not involving any public offering.” In *SEC v. Ralston Purina*, the Supreme Court held that “[a]n offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’”¹⁷ The SEC has implemented section 4(a)(2) by adopting Rule 506 of Regulation D, which contains two different safe harbors for issuers. These exempt offerings under Rule 506 are known as “private placements.”

Rule 506(b)

The most common exempt offering is a Rule 506(b) offering. In 2018, issuers raised roughly \$1.5 trillion through 506(b) offerings.¹⁸ Under Rule 506(b), issuers can sell securities to an unlimited number of accredited investors, and up to 35 non-accredited investors who have enough knowledge and experience in financial matters that they are capable of evaluating the investment.¹⁹ Rule 506(b) also preempts state securities registration. In a Rule 506(b) offering, issuers cannot advertise to the public or use general solicitation to sell securities. If any non-accredited investors participate in the offering, the issuer must provide these investors with certain additional disclosures, including financial statement information, a description of the business, risks the issuer faces, and information about the use of the proceeds of the offering.²⁰ In addition, issuers must file a Form D with the SEC no later than 15 days after the first sale of securities, though failure to file a Form D does not invalidate the exemption.²¹ Finally, securities issued under Rule 506(b) are “restricted securities,” so generally cannot be resold into the market without either: (1) registering the securities with the SEC; or (2) complying with the requirements of Rule 144, including holding the securities for at least 6 months.²²

Rule 506(c)

Another common exempt offering is a Rule 506(c) offering. In 2018, issuers raised \$211 billion through 506(c) offerings.²³ Created by the JOBS Act, Rule 506(c) contains similar limitations as Rule 506(b), except that Rule 506(c) allows issuers to sell securities to an unlimited number of accredited

¹⁷ 346 U.S. 119, 125 (1953).

¹⁸ SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. at 30466.

¹⁹ See 17 C.F.R. § 230.506(b).

²⁰ See 17 C.F.R. § 230.502(b). Moreover, if the issuer provides any *additional* information to accredited investors participating in the offering, then it must also provide the same information to the non-accredited investors. *Id.*

²¹ See 17 C.F.R. § 230.503.

²² See 17 C.F.R. § 230.144.

²³ SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. at 30466.

investors, and issuers *may* use general solicitation, as long as the issuer takes “reasonable steps to verify” purchasers’ accredited investor status.²⁴

Rule 144A

A third common exempt offering is known as a “Rule 144A offering,” which involves a two-step process whereby an issuer sells securities directly to a dealer (typically in reliance on the Section 4(a)(2) exemption for transactions “not involving any public offering”), and then the dealer immediately sells the securities to large institutional investors known as “qualified institutional buyers”²⁵ in reliance on the Rule 144A exemption for the resale of restricted securities.²⁶ In 2017, issuers raised roughly \$1.1 trillion through Rule 144A offerings.²⁷ The vast majority of Rule 144A offerings are debt securities issued by financial institutions.²⁸

Legislative Proposals

H.R. ____: Private Securities Transparency and Reform Act: This discussion draft would require issuers offering securities under Rule 506(b) or 506(c) to file a Form D with the SEC *before* either (1) the first sale of securities, or (2) the commencement of general solicitation. Further, the bill would require issuers to file a closing amendment within 90 days after the offering is *completed* with certain information, including the total size of the offering, the number of investors participating, and fee amounts. The bill states that failure to file Form D or the closing amendment will result in the loss of the exemption. In addition, the SEC would be required to study brokers who primarily deal in exempt offerings, as well as, the relationship between private, quasi-private, and public securities offerings.

H.R. ____: To require the Securities and Exchange Commission to submit a report to Congress about private securities offerings: This discussion draft would require the SEC to conduct an impact study before proposing or adopting any change to a rule regarding either exempt offerings or reporting requirements for public companies. Based on the study, the SEC must submit a report to Congress identifying, among other things, the impact of the proposed change on investors, the expected size of exempt offerings in light of the proposed change, and the impact that the proposed change will have on the public markets.

H.R. ____: Fair Investment Opportunities for Professional Experts Act (Hill): This bill would expand the definition of “accredited investor,” a designation that permits a person to invest in exempt offerings, to include registered brokers and investment advisers, as well as those who have the appropriate education or experience, as determined by the SEC and verified by the Financial Industry Regulatory Authority (FINRA). In addition, the bill codifies the existing annual income and net worth thresholds and requires them to be adjusted every 5 years for inflation. This bill is similar to H.R. 1585 from the 115th Congress, which passed the House by voice vote.

²⁴ See 17 C.F.R. § 230.506(c).

²⁵ A “qualified institutional buyer” (QIB) manages at least \$100 million in securities, and if a bank, has a net worth of at least \$25 million. See 17 C.F.R. § 230.144A(a)(1).

²⁶ See generally SEC, HARMONIZATION OF SECURITIES OFFERING EXEMPTIONS: CONCEPT RELEASE, 84 Fed. Reg. at 30518–30519.

²⁷ See SEC, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009-2017, at 8 (September 11, 2018).

²⁸ *Id.* at 13.

H.R. ____: Crowdfunding Amendments Act: This bill would amend the SEC’s Regulation Crowdfunding to: (1) allow investors to pool their money into a “crowdfunding vehicle,” and (2) raise the public reporting threshold to a level consistent with other exempt offerings. Investors in these funds would also benefit from the advice of a registered crowdfunding vehicle adviser, who would have a fiduciary duty to the fund, and companies would benefit from only having to work with one fund, instead of thousands of small, individual investors. This bill is similar to H.R. 4855 from the 114th Congress, which passed the House by a vote of 394-4.

H.R. 2899: Main Street Growth Act (Emmer/Gonzalez): This bill would allow the SEC to approve a “venture exchange,” a new category of securities exchange that would only trade small public company securities, provided the securities are subject to state oversight and additional ongoing disclosures. The bill also would require the venture exchanges to submit their rule changes to the SEC for approval and provide the SEC with additional discretion to limit over-the-counter trading off a venture exchange. This bill is identical to H.R. 5877 from the 115th Congress, which passed the House by voice vote.

H.R. ____: Rare Disease Fund Act (Vargas): This bill authorizes the SEC to establish an investment fund to invest in early-stage rare disease therapeutics. The Fund would eventually be privately owned and operated, and investments would be funded by equity and bond issuances, with one class of debt guaranteed by the Federal government. The bill would also establish a leverage limit, and includes diversification requirements to minimize the fund’s risks.

H.R. ____: Family Office Technical Correction Act (Maloney): This bill would deem any person who is a family office or a family client to be an accredited investor. Family offices are generally organizations that manage the financial interests of wealthy families. Under current law, if a single client of a family office is not an accredited investor individually, then the entire family office might not be considered an accredited investor, and therefore would be prohibited from investing in private securities. This bill is identical to H.R. 3972 from the 115th Congress, which passed the House by voice vote.

H.R. 609: Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act (Huizenga): This bill would codify an SEC no-action letter²⁹ by exempting certain merger and acquisition brokers from registration as broker-dealers. Under the bill, M&A brokers are defined as brokers that facilitate the transfer of ownership of privately held companies with earnings of less than \$25 million or revenues of less than \$250 million annually (these levels are adjusted for inflation every 5 years). This bill is identical to H.R. 477 from the 115th Congress, which passed the House by a vote of 426-0.

²⁹ Faith Colish et al., SEC No-Action Letter (January 31, 2014), available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2014/ma-brokers-013114.pdf>.