Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment

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The Honorable Carolyn B. Maloney, Chairwoman
The Honorable Bill Huizenga, Ranking Member

Good morning Chairwoman Maloney, Ranking Member Huizenga and members of the subcommittee. It is a pleasure to be a part of this important hearing today, and thank you for the invitation to provide my thoughts on important matter to U.S. entrepreneurship and capital markets.

My name is Douglas Ellenoff. I am a partner at the New York based law firm of Ellenoff, Grossman & Schole. I am a corporate and securities lawyer and have been practicing for over 30 years. My law firm has been in business for more than 25 years and currently we have nearly one-hundred lawyers offering legal services in more than ten practice areas. We are regularly cited as one of the Top 10 IPO law firms in the nation. This year alone we have been involved in more than twenty IPOs. We represent approximately eighty U.S. publicly-traded companies. We are market leaders in several alternative finance programs, including SPACs, PIPEs, Registered Directs and Crowdfunding. We close nearly one-hundred financings a year on behalf of entrepreneurs worth billions of dollars.

I spent nearly five years after the passage of the Jumpstart Our Businesses Act (JOBS Act) working with the leadership of the crowdfunding movement, traveling extensively domestically and abroad, including dozens of trips to Washington, D.C., to provide our views on the proposed and final Regulation Crowdfunding rules and regulations. The various JOBS Act provisions were a meaningful advancement of our securities laws, and Congress should take a victory lap for creating this important tool for entrepreneurs to raise capital. Regulation Crowdfunding has created several thousand jobs and funded nearly 1,000 companies according to the data compiled by Crowdfunding Capital Advisors.

I am counsel to the Association of Online Investment Platforms and have had a prior association with the Crowdfunding Intermediary Regulatory Authority in a similar position.

I am currently Chairman and co-founder of iDisclose/LawCloud, a legal technology document automations company, that has been utilized by crowdfunding entrepreneurs more than two-hundred times to prepare and file their Form C disclosure documents with the Securities and Exchange Commission (SEC). iDisclose also offers apps for Regulation D PPMs and Reg A+ Form 1-A filings.

I am also a co-founder of GUARDD, another development-stage legal technology company that provides updated and ongoing disclosure of private issuers to facilitate secondary trading of their securities. We are seeking to solve securities law difficulties to enable private issuers to comply with the various blue-sky laws.

My comments are those of my own and not my firm, nor my clients or the associations to which I am affiliated with.

I look forward to sharing my views on many of the proposals that will be discussed at today's hearing and thank Chairwoman Maloney and Ranking Member Huizenga for hosting this important hearing today.

INTRODUCTION

Similar to most industrialized nations, the presumption contained in our securities laws is the requirement that any offer and sale of securities must be registered with the Securities and Exchange Commission (SEC). The underlying notion is that the public at large generally needs some protection from bad actors and that full and fair disclosure (i.e., a true and accurate description of the business, its management, the capital structure, financial status of the operations and the associated risks) will be provided to them prior to an investment in order to enable all investors to make an informed investment decision.

Our federal securities laws, as opposed to certain of our states, premise our statutes on the thoroughness of the disclosure of each issuer and not the merits of the investment. Since the enactment of the Securities Act of 1933 and its related provisions in the Securities Exchange Act of 1934, which requires ongoing and updated disclosure by registrants to facilitate secondary trading, it is fair to say that this regime has been the foundation for the most active liquid securities market in the world.

Our securities laws are the basis for many other jurisdictions and are regularly monitored by other governments and regulators to assist in informing their own positions with respect to new innovations and reforms. We too should be mindful of what these other jurisdictions are seeking to accomplish, since they are competing with us to attract companies to raise capital more efficiently and retain these companies for secondary trading.

This is why it continues to be important to analyze what is working with our capital markets and what isn't, or is achievable in new methods with the introduction of new technologies. While I am not an expert in the securities laws of many of the other competitive jurisdictions, it seems to me that based upon many experiences we have had with cross-border transactions and alternative finance programs, that our business enterprises are required to operate in the most complex series of intertwining rules and regulations.

The positive result generally is that our markets are trusted and attract capital from around the world. However, there are negatives that should not be lost or ignored simply because our overall formula for market structure and governance has been unarguably successful.

Is the cost of being public too burdensome? Yes. Compliance costs are causing companies to remain private substantially longer than previously. Although off topic from today's proposals, how is it OK that before SEC proxies by a company in a public merger, the plaintiff's bar is already lining up to claim that there have been deficiencies in the process? It is simply unseemly.

Compliance is unquestionably complex and, in many cases, unclear. While regulators generally are available to provide guidance on how to proceed in a manner that they are comfortable with, there is inconsistency at times. Much of this is just human nature, but creates tension in the system and gives pause to businesses that are considering becoming public in the U.S., or remaining public. In a global market, we need to recognize that our securities laws and how they are interpreted are being assessed around the world to determine if we are a hospitable and beneficial place to entrust their capital formation and trading.

We are here today to consider proposals for improving our capital markets. I will argue that some enhance our standing and others are detrimental. Please consider that as a securities practitioner who respects the efforts of all securities regulators and their daily tasks of protecting investors from the opportunism of bad actors, who are either expedient in their approaches without regards to the impact on others, or the outright wrongdoers, I am very sensitive to the SEC's charter of continually seeking the proper balance between capital formation in both the private and public markets.

EXEMPTIONS

Since the beginning of our Federal securities laws, it has always been acknowledged by Congress and the SEC that not all securities offerings must be, or even should be, registered and reviewed by the SEC.

The statutory inclusion of exemptions from registration with the SEC is an acknowledgment by both Congress and the SEC that there are certain investors that do not need the protections that other less sophisticated and more vulnerable investors may require.

Presumed in these exemptions is the notion that those investors have the ability to make their own informed decisions, perform due diligence, value the companies being considered and structure the financings as appropriate. The benefit of being in this category of investors, albeit whether one is an individual accredited investor or an institutional investor that meets one of the exempted investor categories, is that the private enterprise seeking the necessary funding will not have to subject themselves to the financial, regulatory and administrative burdens of having to register with the SEC.

Being an investment opportunity that can access the private markets is of significant advantage because it saves the time, resources and expense of having to register and comply with the very complex securities disclosure laws and Public Company Accounting Oversight Board (PCAOB) financial statement requirements, among other regulatory costs.

Mind you, neither registering nor being exempt changes the risk profile or investment character of the investment. I would like to emphasize that just because an enterprise is prepared to register their securities and comply with the SEC registration process doesn't makes them a better investment or less risky. The point of registration in my judgment is that we collectively have decided that full and fair disclosure is necessary and it is important to protect unaccredited retail investors from making an uninformed investment decision.

Registration doesn't ensure a successful investment, just relevant information. Since investors in exempt offerings are presumed to be able to protect themselves and not require those protections, a private market has always been in active existence and is substantially larger than our public markets. This is a good thing and the venture markets and real estate markets are a couple of examples of how private entrepreneurship has flourished free from the burdens of registration with a statistically tolerable amount of fraud and litigation profile.

To be clear, however, no amount of fraud is acceptable, and we should and do have laws in place to penalize those that act outside of the bounds. Fraud, unfortunately, does exists. But it should not deter capital formation and capital markets advances.

Are there failures as well as successes? Absolutely. However, as a collective society we are supportive of that subset of the private markets because it does not harm individuals that are not arguably able to bear the risk of those losses. From a practical matter at this point, it would seem unrealistic to me that the existing SEC would even be equipped, much less want, to assume the burden of the tens of thousands of private enterprises that avail themselves of the exempt markets and have raised investor funds.

EXPANDING THE PRIVATE MARKET IN A CONTROLLED AND RESPONSIBLE MANNER

The various JOBS Act provisions that Congress enacted (to its credit) back in 2012 have been beneficial for retail investors while maintaining the appropriate balance between capital formation and investor protection. Notwithstanding a remarkable amount of outspoken investor protection advocacy to the build-up of the passage of the JOBS Act, Title III Regulation Crowdfunding in particular, it is now acknowledged by regulators that none of the doom-and-gloom prognostications of fraud or litigation has presented itself. It is unlikely that fraud won't occur in the Regulation Crowdfunding space, but many of the stated reasons for frustrating this novel exemption have not presented themselves yet.

There is no doubt there have been investor losses (as well as profits). But there has been no meaningful investor upset spilling into the complaint lines of the SEC, FINRA or the state regulators. I believe the reason is that retail investors, through advanced technology solutions, have been appropriately educated about the risks of Crowdfunding in general, as well as being provided with all the necessary business and financial disclosures, along with the associated risks. The digital footprint for recording the full transparency of the process also keeps both sides compliant.

The funding platforms and issuers have properly educated their investors and provided them with limited scaled down legal and financial disclosure in a readable and digestible manner. I am often asked why Regulation CF has only funded a little less than a thousand companies and raised less than a few hundred million dollars. My response has been both that all new programs take a considerable amount of time, based on my experience, to develop if you want them to grow organically and responsibly. Secondly, and more importantly, if the size of the market is the primary issue of concern now rather than problems causing severe regulatory backlash, then we should all be relieved that we have bench-tested the program. And it is working successfully.

Potential for fraud was one of the primary reasons that Congress reduced the maximum amount that companies could raise. And in light of the fact that no fraud has occurred, it should be reconsidered. We should take this opportunity to explore making some improvements, and relaxing some of the unnecessary guardrails of regulation. My observation would be to take a victory lap on this bipartisan initiative, and reflect on what changes are necessary for greater impact. The thousands of jobs that have results from Regulation CF and the businesses that have been funded is a good start!

Improvements to Regulation CF would help more businesses and jobs to be created, more geographically diverse enterprises to be funded, and more entrepreneurial opportunities started by a greater number of minorities and women because they can access capital. To date, entrepreneurs from 48 of the 50 states have raised funding through Regulation Crowdfunding. Now that these positive outcomes have come to pass, additional reforms would fully leverage these early successes.

This is also true of Title II General Solicitation and Regulation A+. I think General Solicitation speaks for its success. Regulation A+ on the other hand needs to still find its footing.

My sincerest emphasis and admonition though for you today, as you consider additional changes and additions to the JOBS Act provisions and other private market proposals, is to remember that Congress took bold bipartisan action in 2012 against much hostility from adversaries of the legislation. Those concerns as stated at that time have not materialized. We have enough information to know that more good can come by enhancing the sound bipartisan legislation that passed in 2012.

VENTURE EXCHANGES

Given the robust nature of our exempt markets/private markets, there has been a generation of enterprises that have raised capital in the private markets, which have no easy method for creating liquidity for those investment positions. Sure, the issuing enterprises may determine that "going public" makes sense and are prepared and willing to expend the considerable funds and resources to IPO or Direct List. Many, dare I say most, do not choose to become public and assume those compliance responsibilities. We must continue to encourage entrepreneurship, making it easier and less burdensome to raise outside capital, and to facilitate these companies to access our public markets.

Every year, 40,000 or more businesses accept private capital and remain outside of the public compliance obligations. That is a lot of private enterprises with outside investors who have no readily available method to facilitate the secondary trading of their securities for those investors who took the risk of making an initial primary investment.

Indeed, the business may pay dividends, get sold or fail, but in the meantime those securities are very difficult to dispossess. Since the dotcom turn of the century, there have been a couple of recognized trading platforms that facilitated the trading of unicorn and minicorn trades. There is pent-up demand for these platforms to create liquidity for those privately held securities. As we speak, there are nearly 40 platforms seeking Alternative Trading System status with FINRA to address the needs of the tokenization movement. Those platforms appreciate the need to establish a means for secondary trading of digitized assets. As these firms commence trading and come into compliance, the entire crypto-industry will bring to funnel through our private and public markets as well, further fostering innovation and new businesses.

Venture Exchanges will satisfy this same need but presumably geared to the venture markets and creating liquidity for those companies. How these Venture Exchanges will be permitted to operate and maintain the spirit of disclosure and compliance with how securities trade on listed exchanges will be quite important to ensure the proper investor protections of the traded securities. The current proposal is necessary to start the process in adopting a solution to this overhanging market problem.

Like other non-public securities offerings, secondary trading will need to be measured and have customized public market analogies of how to transact. Enacting this proposal will be a meaningful advancement for entrepreneurial activity. One only needs to study the unbridled enthusiasm for the funding of blockchain technologies with their associated secondary trading to appreciate that both entrepreneurs and investors are game for this type of approach.

I emphasize that it has to be carefully implemented even though I am supportive that it ought to be enacted. Both the digital asset marketplace and crowdfunding demonstrate that there is a worldwide investor appetite to trade private and digital assets globally.

ACCREDITED INVESTORS

The debate as to which investors ought to have access and exposure to private placements has a long history. Who should have that opportunity? Anything less than everyone is some implicit form of paternalism. While that is certainly true, there is the often-unspoken burden placed on regulators that if we collectively don't exercise some restraint and impose restrictions to protect those that we believe are not sophisticated enough to make an informed investment decision, then many investors will be exploited. Where to draw that line is the battleground of our discussions.

I would point out though that while securities regulators seem to be in the business of protecting investors from themselves, they are also disenfranchising those same people from the basics of capitalism. Yes, they can invest through the public market but that isn't the same. Providing capital to an entrepreneur with an idea you believe in is compelling, even if it fails. Preventing someone from being included in the grassroots of entrepreneurship should be done reluctantly because it causes further divisions even if they should be protected.

Even when the securities laws were originally enacted, after significant investor losses from fraud and abuse, there were express exemptions for investments by friends and families into businesses established by people close to them even though they may lack the necessary sophistication and financial savvy to properly assess the potential investment. That exemption was supposed to be relatively limited and consciously avoid being a public offering to those unknown to them.

With the enactment of Regulation D, a different approach to authorizing exemptions from registration were employed and these are based upon a financial determination of the investors wherewithal to assume the risk of their investment decision. This was less focused on the issuers' community being able to participate, and a more pragmatic financial test was established.

From my professional observations, investors are less likely to complain or litigate about investment loss if they have the means to lose the amount invested and not have it affect their way of living. I recognize that it is imprecise, but it checks out in the real world. Similarly, the more sophisticated investors are about the risk of private investments are less likely to find fault or be upset over a loss.

Investors, including myself, intensely resent a failure by entrepreneurs to provide regular updates advising us of both the bad news as well as the good news. More than outright fraud and misuse, which do happen but are less prevalent than investor protection advocates argue, lack of update and ongoing information is the dominant source of investor consternation. You can lose my investment if the intended business opportunity did not pan out. That's OK. But only telling me about it after it is too late is just unforgivable.

So back to who should be able to have the ability of investing in private offerings. I think it makes eminent sense that there ought to be both a financial measure for be able to make such investments, but also one based upon sophistication. "An educated consumer is our best customer."

Clearly, the finance professor that doesn't meet the current definition of an accredited investor is mistakenly excluded in my judgment, same as with the corporate associate at a law firm or accounting practice. There are too many to enumerate here. But for his reasons I have mentioned above, I am in favor of a proposal to broaden the definition of accredited investor to enable many more people to have access to the private markets.

FORM D

Since the enactment of Regulation D in 1982 and the adoption of Form D, the certainty to executing a compliant private placement has been substantially enhanced. As mentioned earlier, we have established private markets, including real estate and venture capital, that have thrived over the last several decades. As is known to the members of this committee, stability and certainty provide comfort to issuers and investors. Our exempt marketplace has flourished as is and has only been enhanced by the JOBS Act provisions that are only now finding their footing some 7 years after your efforts to achieve that historic results.

Requiring a pre-filing of the Form D is not necessary because much of the additional information being sought can be obtained post-financing. More concerning is the possibility that issuers could lose their exemption entirely for failure to file. The SEC reversed this obligation years ago even though it was initially required. There is no reason to reverse this well considered decision again.

There are also additional uncertainties and concerns about the consequences with respect to state securities law compliance. I take issue with some of the general information being requested, as being both overly intrusive and somewhat burdensome to assemble. I also believe that both the timing and the consequences of the proposal are problematic in my judgment. During the offering process, the issuer has a range of existing commitments in order to proceed with their financing, as do the other professionals, and adding another work stream just doesn't seem justified or wise as a condition to the financing.

Pre-filing with the SEC will also undoubtedly trigger pre-filing with states – putting companies in a position where they will have to make filings and pay fees for financings that aren't necessarily forthcoming or that may not actually close. Besides the potential waste in fees, companies do not want to call attention to a proposed funding round unless they actually raise money.

An additional practical concern is that the filing itself can signal future financing plans or financial trouble that may not come to pass. Customers and employees may misinterpret the filing and unnecessarily raise issues. For similar reasons, we are in disagreement with the post-filing Form D additional requirement. Given the size of the Regulation D market, any such changes to the requirements would certainly unnecessarily cause a percentage of the nearly 40,000 annual issuers to inadvertently fail to comply and lose their exemptions.

STUDIES

While I am generally in favor of studies, since they typically uncover themes and analysis that sometimes are not obvious, I am not a proponent of this proposal primarily because I am against the proposed Form D additional pre and post-filing requirements, and concerned with its timing generally.

As I am sure we can all appreciate, the SEC has asked for commentary on its recently released Concept Release. This endeavor is a substantial undertaking in and of itself and will engage professionals, investors and enterprises from across the country. Reconciling this huge amount of information, submission of comments, and trying to synthesize it in a manner that continues to make our markets the most competitive in the world should be left to the SEC to complete before burdening them with further work like the one being proposed.

Changing the process for entrepreneurs to pursue SEC-complaint private Regulation D offerings should remain as is since this is currently a vibrant and efficient market. Imposing new filing requirements, which could invalidate an issuers exemption, as a means to gather information for the SEC, seems inadvisable to me.

At this time requesting the SEC to conduct a study to understand the market impact would be both overly burdensome and of limited value given their current lack of comprehensive visibility. After the conclusion of this process, Congress should monitor the Concept Release initiative and provide their views, and make adjustments if needed.

Thank you for the opportunity to provide my views and observations. I look forward to your questions and our dialog.