Speech

Big “Issues” in the Small Business Safe Harbor: Remarks at the 50th Annual Securities Regulation Institute

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Thank you Thomas [Kim] for that lovely introduction and I’m very pleased to be here at the Securities Regulation Institute giving the Alan B. Levenson Keynote Address. Director Levenson was the consummate public servant who left an enduring mark on the Division of Corporation Finance, and the Commission more generally. I’m happy to say that his legacy of combating corporate corruption and promoting integrity in our markets lives on today.

Before I begin, let me make my standard disclaimer – the views I express today are my own and do not necessarily represent the views of the SEC or my fellow Commissioners.

The growth of private markets through exempt offerings, the ascension of the once-mythical “unicorns,” and what these things portend for the future of our public markets have been hotly debated topics for some time now.[1] Over the past decades, private securities offerings have grown at a significantly faster rate than public offerings.[2] Companies that contemplate going public are now waiting much longer to do so.[3] Others are choosing not to go public at all.[4] Companies no longer need to go public to raise enormous amounts of capital.

Where we are today is a long way from where we began, when the federal securities laws first established true public markets with certain limited registration exceptions. From the inception of the federal securities laws, companies could choose to offer to the broad investing public by taking on substantial disclosure obligations in exchange for exclusive access to the relatively unlimited pool of public capital; private companies, on the other hand, had to raise capital from insiders or certain large financial institutions, and were subject to restrictions on transfer and resale.[5] Private markets were meant to be the exception to the proverbial rule. But, through decades of legal, regulatory, and market developments, private companies now have access to increasing amounts of private capital, inflating

their sizes and significance to investors and our economy, and all without the concomitant safeguards built into the public markets.[6]

So, how did we get here? Today I'll talk about Rule 506 of Regulation D ("Reg D"). This rule is the primary exemption relied upon by large private issuers to raise essentially unlimited capital from an unlimited number of accredited investors.[7] I will focus on the original intent of Reg D and discuss some of the consequences of allowing limitless capital to flow into the private markets. And, finally, I will suggest some modest reforms.

I. The Origins of Reg D

We could begin this discussion in 1982, when Reg D was codified. But the story really begins with the statute that created the public registration process—the Securities Act of 1933. As everyone in this room knows, the foundational U.S. securities laws were passed in response to the 1929 stock market crash that preceded the Great Depression. Before 1929, all securities markets in the United States were private and thus, dark. The passage of the Securities Act and the Exchange Act, and the authority that Congress gave to the Commission, reflected an intentional and marked departure from that dark default. U.S. securities laws were designed to protect investors in large part by creating public markets, which are subject to registration requirements, and therefore an information sharing process intended to reduce the stark information asymmetry between the issuer of securities and its current and potential investors. This framework, which undergirds the deepest and most liquid capital market in history, intentionally constrained private companies' ability to raise capital if they did not provide registration statements or information of the type a registration statement would provide.[8]

Over the decades, the Commission developed several safe harbors from registration requirements that flow from the Securities Act, including Reg D.[9] Issuances exempted from the requirements of the public markets, however, were imagined to be relatively narrow in scope. As one House Committee Report stated, exempt offerings should be "a specific or an isolated sale of…securities to a particular person"[10] and were intended for limited transactions "where the public benefits are too remote."[11]

Moreover, prior to the passage of Reg D, the Supreme Court had noted that determining whether registration is required or exempt turns on whether investors have access to "the kind of information which registration would disclose."[12]As one Fifth Circuit court noted "if the [investors] did not possess the information requisite for a registration statement, they could not bring their sophisticated knowledge of business affairs to bear in deciding whether or not to invest."[13] In that case, the offering would not be exempt.

And, from its inception, Reg D was intended to facilitate access to capital by small businesses. It was prompted by the Small Business Incentives Act, and is "the product of [the Commission's] evaluation of the impact of its rules and regulations on the ability of small businesses to raise capital."[14] The Commission has continued the expansion of Reg D as recently as 2020 under the auspices of facilitating capital formation for small and medium sized businesses.[15]

So, the Commission coalesced around a narrow exception to the registration requirement for certain (i) private securities offerings, (ii) to a limited type of investor who had access to baseline disclosures, in order to (iii) allow our small business community to grow and thrive. I think we can all agree this is a laudable goal. Small businesses form the backbone of communities, are drivers of jobs, are critical for the development of new ideas and new technology, and are an avenue to wealth creation—all fundamental aspects of the Commission's capital formation mission.[16]

II. **Regulation D Today**

Since 1982, however, Rule 506 of Reg D and other exemptions under Securities Act[17] have changed the landscape of the private markets entirely. Like the children's book, the "Very Hungry Caterpillar," [18] unfettered access to capital through Rule 506 has had a bloating effect on private issuers.[19] Whereas, in prior decades, small private issuers who grew and grew had to turn to the public markets to sate their capital needs, now Reg D, among other legal and regulatory mechanisms, has allowed for the development of pools of private capital sufficient to satisfy the needs of even the largest private issuers.

The clearest evidence of this may be the mere existence of the once-mythical (but now ubiquitous) "unicorns", or private issuers purportedly valued at over a billion dollars. When the term was first coined in 2013, there were 43 unicorns.[20] There are now roughly 1,205.[21] That is an increase of about 121 unicorns in less than one year since I last spoke on this topic. Those unicorns have rough purported overall valuations of about $4 trillion.[22]

And, relevant here, these unicorns have consistently relied on Rule 506 of Reg D to raise billions of dollars in U.S. capital.[23] Make no mistake, Reg D has helped pave the way for the advent of the unicorn. Not only can the companies rely on Reg D to raise capital as small businesses, but they can keep raising capital, and keep growing, indefinitely while staying in private markets. The exception is no longer narrow.

But, there are consequences to allowing issuers to grow so large without any of the requirements of registration.

Investor Protection. First, investors are simply not protected in the same ways in the private markets as they are in the public markets. The Rule 506 safe harbor provides insulation from state blue sky laws and, as I've mentioned, from the registration provisions of the federal securities laws. The current logic for that exemption, more or less, is that if investors are accredited, there is no need for any baseline regulatory disclosure obligations. Many would say, in fact, that large private issuers are backed by the most sophisticated investors in the world and don't need the SEC to impose disclosure or corporate governance protections. I am concerned, though, that sophistication is not quite the safeguard it's presumed to be.

The relevant question perhaps should be, as the Fifth Circuit noted, whether investors have the information needed to bring "their sophisticated knowledge of business affairs to bear in deciding whether or not to invest."[24] As private companies have gained increasingly large market power and as the pool of accredited investors has expanded – including venture capital, private equity funds, mutual funds, pension funds, and individuals that meet the requisite wealth thresholds – the *de facto* presumption that accredited investors need no disclosure isn't panning out.

In fact, history tells a different story when it comes to inadequate underlying information given to or collected by investors. We saw this, for example, in the 2008 financial crisis, and have many recent examples of the continued phenomenon with companies such as FTX, Theranos, and WeWork. Consider FTX in particular – despite the reported presence of many elite and sophisticated investors capable of negotiating for information and protections, FTX was nonetheless described by its court-appointed, post-bankruptcy CEO as marred by "a complete failure of corporate controls" and a "complete absence of trustworthy financial information."[25] Bankruptcy filings indicate that FTX didn't even maintain an accurate list of its bank accounts or account signatories.[26]

Further, when there are wide-spread failures among large private issuers, the spillover effects can go well beyond the investor base of that one company.[27] Other companies and investors almost inevitably get swept up in their wake. In other words, there are market integrity implications to allowing private issuers to grow so big without adequate disclosure or oversight.

Inflated Valuations. Second, allowing nearly unfettered access to private capital in the dark also raises concerns relating to valuation. Private markets today seem to have certain immutable characteristics that, historically, have lent themselves to concerns surrounding valuation – investors may not receive complete or reliable information; securities are generally illiquid, there is limited price discovery and trading can be expensive; and, investors are not guaranteed the best available price when buying or selling the securities.[28]

There is also a set of endemic incentives among institutional private markets to show growth in valuations, all to collect fees. Fund managers rely on the growth of their portfolio companies to propel their fees, to reflect prosperous fund performance, to show healthy assets under management, and to distinguish themselves among a crowded field. Portfolio companies are incentivized to report continuously positive values to show not only the successes of their business, but also to justify the valuations given to earlier round investors, and to avoid their investors from having to suffer write-downs.[29] Ironically, the most reliable valuation practices in the private markets come when the underlying positions are priced with reference to the public markets.[30] But, when there is volatility in those public markets (which bear the benefits of more accurate pricing mechanisms), there is a tendency to drive money into the private markets, either to escape the volatility, or more cynically, simply to avoid the "visible volatility" of the public markets.[31] Investors should not mistake less price transparency, or less "visible volatility," for safer waters. Indeed, the more light that we can shine on the valuation of fund assets – through the work of auditors and the imposition of internal controls around financial reporting– the better we serve all investors and build integrity into this market.

Healthy Corporate Governance. Third, the large and sometimes questionable valuations inure benefits to private issuers in other ways. Academic work has shown the ancillary or collateral effects of private companies that used their amassed market power to distort traditional corporate governance protections – from dual-class share structures, inconsistent disclosure across investors, and conditions that create lax or deficient systems of internal controls.[32]

The Impact on Small Businesses. Finally, another perhaps unintended and perverse consequence of the unlimited nature of Reg D is that it may actually be hurting small businesses it was designed to help. The fact that unicorns and large private issuers are able to continue to raise capital through Reg D, even after they have far outgrown the small business moniker, means that the capital going to large private issuers is locked up.[33] As I've said, private markets are notoriously illiquid, with little price transparency, and with capital often tied up for years on end. And, while information in this space is limited, information that we have collected seems to indicate that large funds and issuers are raising the most amounts of capital under Reg D, and that certain small businesses may be looking to other sources of funding, rather relying than on Rule 506 Reg D.[34]

To me, this says that Reg D is not serving its intended purpose.[35]

III. **Form D Today**

To put this all into context, I've pulled the regulatory filings for two separate offerings. I won't name which companies made these filings.

First the Form D. This is the form ostensibly filed with a Reg D offering. In this case, it's the filing of a unicorn, which purportedly has a valuation of greater than tens of billions.

- The Form is 6 pages long (printed), and consists mostly of check the box answers. The company is seeking to raise over $300 million in funding. It lists whether the company's year of incorporation was more or less than 5 years ago. It lists the principal place of business; it lists certain executives and directors; and it notes the types of securities offered. It ***declines to disclose*** its revenue or net asset value range; it shows no information about sales compensation nor the total number of investors. It's signed by a deputy general counsel, and not a chief officer. That's it. That's all it says. Oh, and, if the issuer fails to file this form, there is really little to no consequence.[36]

The second registration statement is a public offering of securities on Form S-1. Today this company has a market cap of greater than tens of billions, although at the time of its initial offering that number was in the hundreds of millions.

- It is 173 pages before appendices, and (as you all know), contains detailed, descriptive information about the business, the offering, the use of proceeds, risk factors, audited financial data, information on capitalization, dilution, board of directors and director independence, executive compensation, and related party transactions. It also includes the report of an independent registered public accountant, and it is signed by executive officers and directors.

Now, I'm going to posit something that I think we all implicitly know. When you see these two forms you have, more or less, one of two reactions. You either think:

- I am shocked and astounded that a company with a market value greater than the size of many small nations and the ability to impact the economy writ large by its corporate decisions can raise hundreds of millions of dollars of capital by filing a check-the-box form that discloses little more than its address.

Or, you think to yourself:

- Look at the size of that registration statement for the public company. All I see are legal fees and compliance costs and information that most investors aren't even going to read.

Regardless of where one falls on this spectrum, it is clear that the disparity in disclosure is great. But, acknowledging that the private markets have a place, and building on the fundamental successes that we have achieved in our public markets through this mandatory disclosure, oversight and investor protection, I propose incremental reforms to Reg D. There should be more transparency to ensure a basic level of disclosure that allows investors, even the most sophisticated, to make informed investment decisions. And other regulatory obligations should be tailored for size.

IV. Potential Reforms

So what could reforms look like?[37]

a. *Reforms to Form D could give essential information to all private investors, to the public markets and to the regulators, which leads to healthier markets overall*

First, we could revise Form D.[38] Form D could be required to be filed prior to the time any solicitation under Reg D is made.[39] Failure to file a Form D could have actual consequences, such as the inability to rely on Reg D in future offerings.[40] And the Form itself could have useful, substantive information about a private company. For example, its size (by assets, investors and employees), its

operations, its management, its financial condition and revenues, and the volume and nature of the securities offerings.[41] Additionally, the Form could be signed and certified by an executive officer, who would bear accountability for the statements made therein. Form D does not have to contain the level of detail required under an S-1, but it could provide basic, material information about the issuer.[42]

Reforms to Form D can bring material information to investors, curing (at least to a degree) the informational asymmetry that is allowed currently.[43] Requiring information about the use of offering exemptions can also bring important systemic information to our Divisions of Corporation Finance and Investment Management, to Congress, as well as to academics for data analyses and a more thorough understanding of our private markets more generally.[44] Finally, greater transparency around the use of exempt offerings can potentially shed light on fraudulent offerings or offering practices, and hopefully, in some instances, prior to investor loss.

b. *Heightened Obligations Could Be Imposed Upon Large Private Issuers and Large Capital Raises, Consistent With Previous Reforms*

And second, we could import a two-tiered framework, similar to that under Regulation A (often referred to as “mini-IPO offerings”), which would impose certain heightened obligations on the larger private issuers and issuances. Recall that under Reg A, there are two separate levels of offerings, based on the amount of capital raised.[45] Both tiers are subject to basic requirements as to issuer eligibility and disclosure. For example, Tier 1 and Tier 2 issuers must file an offering circular, subject to review and qualification by the staff, and must file two years of financial statements.[46] But Tier 2 offerings – for larger raises – are subject to heightened requirements. Tier 2 offerings, for example, must disclose to prospective investors financial statements, audited in accordance with GAAS by an independent accountant. Additionally, they must file annual, semiannual, current and special financial reports with the Commission. The scaled disclosure framework is also used for public reporting companies – with more limited disclosures for newer and smaller public companies and also accelerated filing deadlines for larger public companies.[47] Smaller Reporting Companies (“SRCs”), for example, have reduced narrative disclosure obligations and can provide audited financial statements for two years rather than three.[48]

The adoption of a tiered framework for Rule 506 recognizes that not all offerings are created equally. I envision that, like Reg A, different sizes of offerings would trigger different disclosure obligations. But unlike Reg A, additional obligations would be triggered by the *size of the company*, in terms of market cap, value or the size of the investor base. In other words, large private issuers – and not the small businesses at the heart of Reg D – would have additional obligations.[49] I believe that, at a minimum, large private issuers could bear heightened disclosure obligations, over and above what would be required of Form D, at offering and on an ongoing basis. For example, they could be required to engage independent auditors and would have to provide prospective and committed investors with financial statements audited in accordance with GAAS, along with auditor opinion letters, confirming the adequacy of the company’s internal controls over financial reporting.[50]

To my mind, this is a tailored solution that helps us fulfill our mandates. First it imposes heightened obligations on larger private companies. In so doing we would both acknowledge Reg D’s purpose in allowing reprieve to smaller businesses, and also help eliminate the benefit and effective subsidy being given to large private issuers on the backs of these same small businesses. Second, it provides broader disclosure to investors, which acknowledges again that, even among a set of accredited and sophisticated investors, private market investors are entitled to a certain basic set of information.

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As I alluded to earlier, the reforms we propose to Reg D are incremental, but essential. These are among the critical reforms that we can make to ensure that our private markets operate as originally intended. Let's ensure the exemption operates as designed.

Thank you.

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[1] According to the most recent SEC data, for the 12 month period from July 1, 2021 through June 30, 2022, exempt offerings accounted for approximately $4.45 trillion in capital raising (a likely underreported number); whereas during that same time period, publicly raised funds accounted for roughly $1.23 trillion in fundraising. Fiscal Year 2022 Office of the Small Business Advisor Annual Report, at 19. That's roughly 3.5 times more capital raised in the private markets than in the public markets. IPOs, once the seminal form of going public, accounted for $126 billion of that capital raised. *See also* SEC 2020 Report to Congress on Regulation A / Regulation D Performance (Aug. 2020) at 41, Table 12.

The public and private market framework is the creation of securities laws and regulations laying out when disclosure and registration are required. *See, e.g.,* Written Testimony of Elizabeth De Fontenay, Before the United States House of Representatives, Committee on Financial Services, "Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment," (Sept. 11, 2019). During the prior administration, there was a deregulatory push to allow for additional capital to be raised in the private markets. *See, e.g.,* Adopting Release, Accredited Investor Definition, Rel. Nos. 33-10824; 34-89669 (Aug 26, 2020); Adopting Release, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Rel. Nos. 33-10884; 34-90300; IC-34082 (Nov. 2, 2020). But despite the obvious correlation between the public and private markets, such rules were passed without attendant research as to their impact on the public markets, or consideration of correspondent rulemaking to facilitate capital formation in the public markets.

[2] *See, e.g.,* McKinsey & Co., Private Markets Come of Age: McKinsey Global Private Markets Review 6 (2019). *See generally* McKinsey & Co, Private Markets Rally to New Heights: McKinsey Global Private Markets Review (2022); Joan Farre-Mensa & Michael Ewens, *The Evolution of the Private Equity Market and the Decline in IPOs*, Harv. L. Sch. F. Corp. Governance (Sept. 28, 2017); Morgan Stanley,*Public to Private Equity in the United States: A Long-Term Look*(Aug. 4, 2020) ("[C]ompanies have raised more money in private markets than in public markets in each year since 2009") (*citing* Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, Division of Economic and Risk Analysis, U.S. Securities & Exchange Commission (August 1, 2018)).

[3] *See, e.g.*, George S. Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.J.L. & Bus. 221, 227-29, 241 (2021); Samantha Sharf, *Is The IPO Outmoded? Why Venture Backed Companies Are Waiting Longer to Go Public*, Forbes (Dec. 24, 2014); Timothy B. Lee, *Companies Are Waiting Longer and Longer to Go Public. Here's Why*, Vox (Sept. 11, 2014)

[4] *See, e.g.*, Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.J.L. & Bus. at 227-29; McKinsey & Co., *Grow fast or die slow : Why unicorns are staying private* (May 11, 2016).

[5] *See* Elizabeth De Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 Hastings Law Journal 445, 448 (2017) ("From their inception, the federal securities laws proposed a simple bargain to U.S. companies: disclosure in exchange for investors."). Further, it is important to note that there is a robust exempt offering framework outside of Rule 506 of Regulation D, including Rule 504 of Regulation D, Regulation A, Regulation Crowdfunding, Rule 147 (17 C.F.R. § 230.147), Rule 144 (17 C.F.R. § 144), Rule 144A debt issuances (17 C.F.R. § 230.144A).

[6] *Cf.,* De Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, at 466-472 (arguing that the deregulation of private capital over the past few decades have played a role in the decline of equity capital raising in the public market).

[7] General solicitation is not permitted in connection with Rule 506(b) offerings. The offerings are limited to "accredited investors" and 35 non-accredited, but sophisticated, investors. 17 C.F.R. § 230.506(b); *see also* 17 C.F.R. § 230.502.

[8] *See S.E.C. v. Ralston Purina*, 346 U.S. 119 (1953) (holding that "the focus of the inquiry should be on the need of the offerees for the protections afforded by registration. The [investors] here were not shown to have access to the kind of information which registration would disclose.").

[9] In 1974, the SEC adopted Rule 146, an exception from registration under Securities Act Section 4(2) for unlimited amounts of capital, which in practice was underutilized, particularly by small businesses, due to the limited relief it provided. In 1975, the SEC adopted Rule 240 in response to limitations of Rule 146. Rule 240 provided a much broader, less onerous exemption for small companies selling up to $100,000 in securities. At the time, the SEC explained the exemption as one "where, because of the small size and limited character of the offering, the public benefits of registration are too remote." Securities Act Release No. 5560, 6 SEC Docket 132, 1975 WL 160968, at *1 (Jan. 24, 1975). In 1978, the SEC adopted Rule 242, a more moderate exemption for offerings of up to $500,000 in securities. In 1982, the SEC adopted Regulation D. Rules 504, 505, and 506 replaced 240, 242, and 146, respectively.

[10] *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATIONS § 3-C-7 (3d ed. 2004) (citing House Committee Report).

[11] Comm. on Interstate & Foreign Com., House Report on Securities Act of 1933, H.R. Rep. No. 73–85, at 5 (1933).

[12] *See Ralston Purina*, 346 U.S. 119.

[13] *See Hill York Corp. v. American International Franchises, Inc.,* 448 F.2d 680, 690 (5th Cir. 1971).

[14] Adopting Release, Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Rel. No. 33–6389 (Mar. 8, 1982), 47 Fed. Reg. 11251.

[15] In support of the 2020 Harmonization rules, Chair Clayton noted that amendments were being implemented to provide "a more rational framework that [would] facilitate capital formation for small and medium sized businesses and benefit investors for years to come." Press Release, *SEC Harmonizes and Improves 'Patchwork' Exempt Offering Framework*, SEC Press Release No. 2020-273 (Nov. 2, 2020) (*quoting* Chairman Jay Clayton).

[16] The SEC's tri-parte mission is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.

[17] *See supra* at n. 5.

[18] Eric Carle, The Very Hungry Caterpillar, World Publishing Company (1969).

[19] Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.J.L. & Bus. 221 (2021) at Figure A-8; Daria Davydova, Rüdiger Fahlenbrach, Leandro Sanz, & René M. Stulz, *The Unicorn Puzzle*, Oct. 2022 (finding that unicorn status enables startups to access new sources of capital).

[20] Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms* 18 N.Y.J.L. & Bus. at 227.

[21] CB Insights – the Complete List of Unicorn Companies. At the time of this speech, CB Insights was reporting 1,204 Unicorns.

[22] *Id.*

[23] See, e.g., Form D Filings by (just to name a few): Space Exploration Technologies Corp dated 8/5/2022, 6/13/2022, 12/29/2021, 11/15/2021, 2/23/2021, 8/18/2020, 3/13/2020, 7/9/2019, 4/17/2019, 1/3/2019, 4/18/2018, 8/8/2017, 1/26/2015, 11/9/2010, 3/31/2009, 8/4/2008, 8/19/2002 (reflecting individual offerings of up to $2 billion in a single offering); Stripe, Inc. dated 3/26/2021, 5/4/2020, 10/4/2019, 9/3/2019, 2/8/2019, 10/5/2018, 3/13/2018, 7/31/2017, 3/30/2017, 12/23/2016, 12/6/2016 (reflecting individual offerings of up to $630 million in a single offering); FTX Trading, Inc. dated 11/2/21, 8/5/21 (reflecting individual offerings of up to $1bn); Theranos, Inc. dated 5/30/2017, 7/8/2010, 11/17/2006, 2/21/2006, 1/3/2005 (reflecting individual offerings of up to $582 million in a single offering (for those Form Ds electronically available); Canva, Inc. dated 9/27/2016, 10/9/2015, 6/20/2014, 3/6/2014, 3/21/2013, 8/16/2012 (reflecting individual offerings of up to $27 million in a single offering); Databricks, Inc. dated 9/15/2021, 2/2/2021, 11/5/2019, 2/7/2019, 8/22/2017, 7/3/2014, 9/25/2013 (reflecting individual offerings of up to $1.6 billion in a single offering).

[24] *See Hill York Corp.*, 448 F.2d at 690.

[25] Declaration of John J. Ray III In Support of Chapter 11 Petitions and First Day Pleadings, *In Re FTX Trading, LTD., et al.,* No. 22-11068, (Bank. Ct. D. Del. 2022), Dkt. No. 24, ¶ 5 (In full: "Never in my career have I seen such a complete failure of corporate controls and such a complete absence of trustworthy financial information as occurred here. From compromised systems integrity and faulty regulatory oversight abroad, to the concentration of control in the hands of a very small group of inexperienced, unsophisticated and potentially compromised individuals, this situation is unprecedented."); Jason Zweig, Why the Investing Pros Were Such Suckers for FTX*,* Wall Street Journal (Nov. 22, 2018); Elliot Brown, New CEO Says FTX Suffered 'Complete Failure of Corporate Controls', Wall Street Journal (Nov. 18, 2022).

[26] Declaration of John J. Ray III In Support of Chapter 11 Petitions and First Day Pleadings, *In Re FTX Trading, LTD., et al.,* No. 22-11068, (Bank. Ct. D. Del. 2022), Dkt. No. 24, ¶ 50.

Any statements made here are based solely on media reports and public information, and are without judgment as to the presence or absence of liability or culpability in connection with any ongoing investigations or actions, or those that may occur in the future.

[27] These types of misconduct or unaddressed red flags in the private markets could flourish, even with the presence of sophisticated investors, when the pools of private money and "dry powder" are so frothy that issuers could have the upper hand and the ability to convince (even sophisticated) investors

that they will miss out on a unique opportunity unless they invest quickly, and potentially without critical information.

[28] *See, e.g.*, Mark I. Steinberg, Rethinking Securities Laws, Oxford University Press (2021) ((In order "[t]o have effective access, the individual or entity must have sufficient leverage to induce the issuer to make available the type of information that would be provided in a registration statement. Ordinarily, only the issuers' insiders (and perhaps their family members) and investors whose financial contribution is central to the consummation of the offering will have such leverage.") *citing Doran v. Petroleum Management Corp.*, 545 F.2d 893, 906 (5th Cir. 1977)).

[29] Matt Levine, Money Stuff, Private Markets Don't Like to Go Down (Jan. 4. 2023).

[30] *See, e.g.*, Elizabeth De Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 Hastings Law Journal 445, 490-494 (2017).

[31] Matt Levine, Money Stuff, Private Markets Don't Like to Go Down (Jan. 4, 2023). ("One cynical way to understand private investing generally is that private investment firms —venture capital, private equity, private real estate, etc. —chargetheir customers high fees for the service of avoiding the*visible*volatility of public markets. If you invest in stocks, sometimes they go up, and other times they go down. If you invest in private assets, they don't*trade*; sometimes they go up (because companies raise new rounds of capital at higher prices), butthe companies and the investment managers take pains to keep them from going down.")

[32] *See, e.g.,* Robert J. Jackson, Testimony before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets of the Committee on Financial Services (Mar. 30, 2020) ("But exchanges' weak incentives to help investors hold corporate insiders accountable [and impose limits on governance issues such as dual-class shares] are now coupled with the explosive growth of our private capital markets. As my friend and colleague Commissioner Allison Lee has ably explained, the growth of private markets is not an accident, but instead a consequence of deliberate policy choices. Those choices have created new sources of private capital, increasing founders' power, and while sophisticated early-stage investors are able to bargain for contractual provisions that protect their rights, ordinary investors in initial public offerings do not have the same opportunities. Thus, any changes to the balance between public and private markets should consider the effects of expanding private markets on investors' power to hold insiders accountable in public markets."); Mark Steinberg, Rethinking Securities Law at 54 (noting that only the issuers that are required to consummate the transaction have the bargaining power to demand disclosure with registration-type information, others do not have that bargaining power and receive less information).

[33] *See* Daria Davydova, Rüdiger Fahlenbrach, Leandro Sanz, & René M. Stulz, *The Unicorn Puzzle* (Oct. 2022) (finding, among other things, unicorns have access to additional pools of capital).

[34] Data collected by DERA and presented to Congress shows that the overwhelming amount of funds collected through Reg D go to private funds. Sec. & Exch. Comm'n, 2020 Report to Congress on Regulation A / Regulation D Performance (Aug. 2020) ("The largest category of issuers in the Reg D capital market, based on the amount sold, are pooled investment funds (predominantly private funds), which include hedge funds, venture capital (VC) funds, PE funds, and other pooled investment vehicles.") And, "among Reg D issuers that report size, large issuers (greater than $100 million in revenue) account for a greater share of the proceeds." *Id.* at 24. Thus, for example, the mean offer size between 2009 – 2019 for Reg D issuers (for reported issuances) was approximately $71 million. While

the frequency of offerings by small issuers is much greater than those of large issuers, the amounts are much less, and they seem to be concentrated in urban centers. Thus, for example, most Reg D issuers are in New York and California. *Id.* at 22. Small rural issuers rely much more on small banks as a source of funding, and small rural issuers reliance on Reg D accounts for a less than 1% of raises. *See, e.g.,* Fiscal Year 2022 Office of the Small Business Advisor Annual Report, at 66-67.

[35] Some have argued that it is the unruly and costly regulatory framework that is bleeding the public markets. But that seems to be belied by the data. *See* Elizabeth De Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 Hastings Law Journal 445, 463-465 (2017) (finding that the data is inconclusive as to whether legal and compliance costs have led to the growth in the private markets, and positing instead that the deregulatory framework is the greatest contributor).

[36] Failure to file a Form D does not invalidate the exempt offering, and we understand that law firms have advised that filing a Form D is considered somewhat voluntary. It is common practice for Form Ds to go unfiled or to be filed with partial or incomplete information. U.S. Sec. & Exch. Comm'n, Office of Inspector General,: Regulation D Exemption Process at 27 (March 31, 2009) ("In fact, [officials from the Division of Corporate Finance] have informed us that many companies that rely on the Regulation D exemption reportedly do not file a Form D, and that issuers' lawyers frequently advise their clients that Form D is essentially voluntary.")

[37] Of course, I will keep an open mind to public feedback, and if we do move forward with any rulemaking on this topic, to commenters' input.

[38] Form D is currently required to be filed in connection with exempt registrations made under Rule 504 or 506 of Regulation D, or under Section 4(a)(5) of the Securities Act.

[39] Currently, a Form D must be filed 15 days after the first sale of securities in the offering. This framework, however, does not allow all investors to benefit from the information that would be contained in the form, nor does it allow the Commission to consider the information prior to a potentially fraudulent, or otherwise improper, sale.

[40] Amendments to Regulation D, Form D and Rule 156 under the Securities Act (proposed 2013) ("We understand that some issuers are not making a Form D filing for Rule 506 offerings because the filing of Form D is not a condition of Rule 506.")

[41]*See, e.g.*, *id* at section II.s

[42] In addition to the above, we could also consider requiring information relating to the use of proceeds, the nature of the investor base (including information about accredited and unaccredited investors and steps taken to assure accreditation), expected returns through distributions, findings of securities fraud, enforcement actions or non-compliance with the securities laws, material risks and conflicts of interest, and the availability of secondary trading. The Form could also require an amendment or closing statement of amounts actually raised under the offering.

[43] Reg FD limits selective disclosure in the public markets, but not in the private markets. *See generally* Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release No. IA-5955 (proposed Feb. 9, 2022) (describing information asymmetries between private fund issuers and investors, for example, "we continue to observe that private fund investments are often opaque; advisers frequently do not provide investors with sufficiently detailed information

about private fund investments. Without sufficiently clear, comparable information, even sophisticated investors would be unable to protect their interests or make sound investment decisions.")

[44] Requiring mandatory additional disclosures of large and potentially systemically important private issuers can help mitigate financial stability concerns.

[45] Tier 1 is an exemption that applies to offerings that do not exceed $20 million over a 12 month period; and Tier 2 covers offerings that do not exceed $75 million, similarly over a 12 month period. 15 C.F.R. 230.251.

[46] *See* Final Rule, Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), Rel. Nos. 33-9741; 34-74578; 39-2501 (Mar. 25, 2015).

[47] *See* Smaller Reporting Company Definition, Release No. 33-10513 at 7 (June 18, 2018). Further, Emerging Growth Companies also benefit from reduced narrative and S-X disclosures, and do not have to provide auditor attestation of internal control over financial reporting under SOX 404(b). *See also* 15 U.S.C. §77b(a)(19) (defining Emerging Growth Companies). *See generally* U.S. Secs. & Exch. Comm'n, Emerging Growth Companies. Finally, the largest public issuers have the shortest window to file periodic reporting.

[48] *See* 17 C.F.R. § 229.10(f)(1) (requirements for smaller reporting companies); 17 C.F.R. 210.8-01 through 210.8-08 (financial statement requirements for smaller reporting companies).

[49] The size of the issuer that would trigger the heightened obligation could be determined through analysis in connection with rulemaking.

[50] Also acknowledging the need for more disclosure among our nation's largest private companies, recent legislation was proposed in the Senate, would add new thresholds for registration to the Exchange Act based on the size of a company. See S. 4857 (117th Congress), The Private Markets Transparency and Accountability Act (2022) (proposing amendments to Exchange Act Section 12(g), including registration requirements for private companies whose values exceed $700 million, or where revenues exceed $5 billion and that employ not less than 5,000 employees). Additionally, the Commission could consider re-framing of the definition of "holder of record." *See* Comm'n Allison Herren Lee, Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy, (Oct. 12, 2021).