Securities Regulation Daily Wrap Up, SECURITIES OFFERINGS—House FSC Republicans kick off new Congress with slate of capital formation, accredited investor drafts, (Feb. 9, 2023)

Securities Regulation Daily Wrap Up

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The GOP-led bills would open private markets to more investors by codifying some existing SEC guidance, expanding the definition of "accredited investor," and adding to reforms first introduced in the JOBS Act.

The Republican leaders of the House Financial Services Committee's Subcommittee on Capital Markets held two hearings on a set of discussion drafts aimed at promoting a package of capital formation bills. The combined 18 discussion drafts underlying the two hearings would address a variety of issues, including accredited investors, crowdfunding, micro-offerings, venture capital funds, Regulation A, and broker-dealers who function as private placement brokers and finders. Many of the discussion drafts have been introduced in previous Congresses and may not have an obvious route to enactment, but it is at least conceivable that a few of them could eventually garner enough support to be enacted via an appropriations omnibus or other JOBS Act-focused reform package, much as has been the recent practice among lawmakers.

Capital formation themes. A noticeable feature of this Congress's first foray into capital formation is how no member of the Subcommittee on Capital Markets worried aloud about there being too few IPOs, although Subcommittee Ranking Member Brad Sherman (D-Calif) noted that a few dozen large private companies might be "encouraged" to go public. Rather, the discussion was primarily about how to make private markets more accessible to retail investors (and whether the proposals lack investor protections), something very different from the discussions just five or six years ago when members puzzled about why there are fewer IPOs and, thus, fewer opportunities for retail investors to invest in new companies.

Starting with the second hearing dealing with barriers small businesses face in raising capital is helpful because it spotlights the main rift among law makers: should the SEC proceed with rules to push companies into public markets or should Congress further open private markets to more investors. Subcommittee Chair Ann Wagner (R-Mo) said Republicans believe in small businesses raising money with as little friction as possible and that the JOBS Act of 2012 was step in the right direction.

Rep. Wagner began questioning the panel of witnesses by citing a recent speech by SEC Commissioner Caroline Crenshaw while asking whether it is easier or more difficult for businesses to raise money. In the speech, Crenshaw had observed that private offerings now outpace public offerings, more companies can stay private longer, and that some companies elect never to go public. Crenshaw also noted that information asymmetries permeate the private markets and that even accredited investors need more disclosure about the companies in which they invest. Crenshaw also offered a number of potential reforms, largely aimed at Regulation D, the primary source of the exemptions many companies now use to remain private.

In response to Rep. Wagner's question, Doug Ellenoff, a partner at Ellenoff Grossman & Schole LLP, replied that there is a "troubling coordinated narrative we're hearing." In his prepared remarks, Ellenoff expressed support for many of the discussion drafts floated by the subcommittee.

In response to questions from Rep. Sherman, the subcommittee's Ranking Member, and Juan Vargas (D-Calif), Alexandra Thornton, Senior Director at the Center for American Progress, spoke about two things she views as problematic about private markets. First, she said the definition of holder of record, which the JOBS Act increased, may obscure the true number of shareholders in private funds because a single intermediary can hold shares for many investors.

Thornton also explained that in private markets, there often is not much disclosure by companies to investors, information that is available may be untimely, and financials are not always subject to independent audits. She said these circumstances can lead to inflated valuations. Current exemptions, she added, allow companies to stay private longer and when they do go public retail investors often lose because the once private company had been overvalued.

Deborah Gladney, co-founder of WorkTorch, noted in her prepared remarks that startups with all-women founders and black founders each receive less than 2 percent of available venture funding. In response to questions from Rep. Alexander X. Mooney (R-WVa), Gladney, whose firm is based in Wichita, Kansas, explained that relationships are critical and that entrepreneurs who live in locations where these networks are absent may find themselves excluded from funding networks. (The House recently passed the Expanding Access to Capital for Rural Job Creators Act (H.R. 298), which would require the SEC's Advocate For Small Business Capital Formation to mull issues that affect rural businesses, in addition to its existing duties regarding minority- and women-owned small businesses and small businesses affected by hurricanes or other natural disasters).

Also in response to a questions from Rep. Mooney, Darcy Howe, Founder and Managing Director of KCRise Fund, explained the importance of demo days for small businesses, especially those located in cities with less support from venture investors. House Republicans are proposing to reintroduce the Helping Angels Lead Our Startups (HALOS) Act, which would ease limits on demo days.

In prepared remarks, Howe also said the proposed Improving Capital Allocation for Newcomers (ICAN) Act would have the greatest impact in freeing up capital for smaller venture funds. Mac Conwell, Founder and Managing Partner of RareBreed Ventures, offered a personal story of why the ICAN Act is needed. According to Conwell, his first fund raised money from a diverse group of investors via Rule 506(c) of Regulation D and a social media campaign (Rule 506(c) allows for general solicitation in some instances). Conwell's second fund, however, relied on Investment Company Act Section 3(c)(1) and his investors from the first fund are now mostly "price[d] out" of the second fund because minimum investment levels are much higher. The ICAN Act would raise the numerical and financial thresholds for beneficial owners and qualifying venture funds.

The second hearing was in essence a good transition to the earlier hearing because it more explicitly highlighted the problems of secretive and overvalued private companies. The issue of the lack of information about private companies would repeatedly arise in the first hearing on accredited investors.

Accredited investors. The first meeting focused on whether and how to expand the definition of "accredited investor" under federal securities regulations, although the hearing also included discussion drafts that would expand access to closed-end funds by retail investors and afford gig economy workers similar compensation schemes as salaried workers. The drafts would open the accredited investor standard to include persons who have achieved this status via an examination, self-certification, whose investment is no more than 10 percent of the greater of their net assets or annual income, and to persons who receive individualized investment advice or recommendations from someone with one or more professional designations (The SEC amended the definition of "accredited investor" in August 2020 to, among other things, create new categories of qualifying natural persons based on professional certifications and designations that suggest these persons' financial sophistication).

Subcommittee Chair Wagner opened the accredited investor hearing by urging members to back legislation that would expand opportunities for all investors and entrepreneurs in order to achieve long-term, sustainable growth. She said that private offerings can be more cost efficient, but that wealth and other limiting criteria result in the exclusion of too many investors from these markets.

Representative Sherman suggested that the hearing's focus is that investor protection is a barrier—which he said it is—but went on to suggest in his later closing remarks such barriers should be rationalized without lowering regulatory standards.

Omi Bell, founder of Black Girl Ventures, testified that while she generally does not support deregulation, she nevertheless wants currently excluded communities to have investment opportunities. During questioning by Rep. Gregory W. Meeks (D-NY), who noted that he had referred his niece to Bell's organization, Bell was asked what disclosure would be best suited for new accredited investors. According to Bell, due diligence and pro-forma financials are important, but she added that there is a network effect in which entrepreneurs need to be walked into different networks to raise funds.

In her prepared remarks, Bell observed that "[d]ue to systemic barriers to generational wealth and widening wealth inequity, most founders in the Black community cannot tap a network of friends or family to provide seed funding for their business, and investment opportunities to scale businesses are even further out of reach."

Panelist David Olivencia, CEO of Angeles Investors, recalled an exchange with a prospective angel investor who did not qualify as an accredited investor. "To emphasize my point, I will tell a true story about Carlos, a young professional from Southern California who earned an MBA from a leading university. As Angeles Investors was preparing to invest in the seed round of Canela Media, he approached and passionately asked if he could invest. I asked him if he qualified as an accredited investor and he sadly said 'no.' He asked, 'is there another way? I really believe in the company, the CEO, and understand their business model through my MBA studies.' I said, 'sadly you can't.'"

Eli Velasquez, Founder & Managing Partner at Investors of Color Network, responding to questions posed by Rep. Vargas, said that angel investors had become more professionalized and that angels would not want to have a reputation for sharing bad deals.

Jennifer Schulp, Director of Financial Regulation Studies at the Center for Monetary and Financial Alternatives at the Cato Institute, similarly urged Congress to expand the definition of accredited investor. In her opening remarks, she noted that there are too few investment choices and that the ones that are left for non-accredited investors may have lower returns. Schulp also observed that current accredited investors tend to be white and clustered on the U.S. coasts.

Gina-Gail Fletcher, Professor of Law at Duke University School of Law, testified that there is a need for robust securities laws because that is how information gets to investors. Specifically, she explained that private markets are the opposite of public markets in that private markets lack many of the mechanisms for getting information to investors. In her view, that is a scenario that can increase wealth extraction and inequality.

Discussion draft spotlight: finders. Most of the discussion drafts put forward by GOP members of the Capital Markets Subcommittee are reintroductions, including this article's feature bill, the Unlocking Capital for Small Businesses Act, as-yet without a sponsor in the current Congress but which has been around since at least the 115th (H.R. 6127) 116th (H.R. 3768) and 117th (See S. 3922; H.R. 8998) Congresses when it was sponsored each time by then-Rep. Ted Budd (R-NC) (now Sen. Budd), and only more recently by Sen. Kevin Cramer (R-ND).

The latest discussion draft would, like its predecessors, create a safe harbor for the activities of private placement brokers and finders. Given the discussion draft's similarities to the recently enacted Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act (See Title V of Division AA of the Consolidated Appropriations Act, 2023 (H.R. 2617), the question arises whether the discussion draft on private placement brokers and finders, perhaps with additional revisions, could eventually find its way into law.

The status of finders has been a long-running issue that, much as with M&A brokers, turns on the degree to which a person acts like a broker-dealer and must then register with the SEC. Moreover, also like M&A brokers, for which the SEC had issued guidance, private placement brokers and finders have looked to SEC no-action letters and have been the subject of a proposed SEC exemption, but the proposal has not advanced since it was issued in 2020.

The discussion draft would define "private placement broker" as a person who, among other things, receives transaction-based compensation for effecting a transaction by introducing an issuer of securities to a buyer of the securities, but who does not handle or take possession of funds or securities, does not engage in activities

that require registration as an investment adviser under federal or state law, and does not meet the definition of "finder." "Finder" would be defined as a person who otherwise meets the definition of "private placement broker" but who also satisfies limits on calendar-year transaction-based compensation (generally no more than $500,000), or who stays within the dollar limits for transactions involving a single issuer, a combination of issuers, or stays within the numerical transaction limit of fewer than 16 transactions per calendar year which cannot be part of the same offering or are otherwise unrelated.

The discussion draft would direct the SEC to adopt rules for private placement brokers that are similar to those for funding portals in the crowdfunding context. National securities associations would be required to allow private placement brokers as members. To claim the safe harbor, a private placement broker would have to make certain disclosures that are clear, conspicuous, and in writing. Finders would be exempt from registration with the SEC and would not be required to become members of a national securities association. State securities regulators would be barred from imposing requirements for registration, audits, financial recordkeeping, or reporting requirements on private placement brokers and finders that are greater than those imposed under the terms of the discussion draft.

The private placement broker/finder discussion draft was one of several GOP discussion drafts explicitly mentioned during the Capital Markets Subcommittee's capital formation hearing. During questioning from Andrew Garbarino (R-NY), panelist Ellenoff opined that there are no good reasons not to have finders be able to qualify under the old Paul Anka test or some expanded no-action letter.

That view, however, is not necessarily universal, as exemplified by statements from two commissioners who dissented from the SEC's 2020 proposed exemption for finders. When a finders exemption, for example, is limited to existing SEC guidance, there tends to be somewhat more eagerness to do something on finders, but an expansion of that guidance to include more broker-like activities tends to remain controversial.

The Commission majority noted in the notice for the proposed exemption that some regions that lack venture capital and angel investors might be better served by finders. The proposal also noted that finders may help to bring together investors and traditionally underrepresented founders, including women and minorities.

The proposed exemption would have created two tiers of finders, one that would allow the provision of prospective investors' contact information on a limited basis, and a second tier that would allow the solicitation of investors within a limited scope of activities. Absent an exemption, persons acting as finders would likely continue to rely on SEC no-action letters, such as the Paul Anka letter. Both the Paul Anka letter and the proposed exemption would require that prospective investors be accredited investors (See also, SEC press release, and statements in support of the proposed exemption by then-SEC Chair Jay Clayton, former Commissioner Elad L. Roisman, and Commissioner Hester M. Peirce).

In dissent, then-Commissioner Allison H. Lee noted that Tier I would simply codify SEC no-action relief, while Tier II would open a new category of finders that can act almost identically to a registered broker-dealer. Lee also questioned the use of the Commission's exemptive authority rather than the formal rulemaking process because the exemption would allow the Commission to avoid providing an economic analysis justifying the exemption. Lee suggested that she could have backed a proposal for a "scaled registration format that required, at a minimum, some form of record keeping and examination authority."

Commissioner Crenshaw, much like Commissioner Lee, concluded that she might be able to support "clarifying grey areas in our regulatory framework, especially where doing so may facilitate capital formation for smaller issuers and women- and minority-owned businesses." For Crenshaw, however, providing early echoes of her more recent speech mentioned by Rep. Wagner during the capital formal hearing, moving forward with an exemption for finders would be unwise given the SEC's lack of data on how private markets work. Crenshaw also said the proposed exemption would lack sufficient investor protections.

Comments on the proposed exemption were mixed. For example, Sara Hanks, CEO of CrowdCheck, Inc., noted the "many negative responses" while also urging the Commission to move forward with the proposal, even if it is imperfect, provided the Commission make some changes to clarify the exemption, including

potentially withdrawing the Paul Anka no-action letter. Hanks also described the situation for investors and small businesses: “The reasons for inability to engage professional investors or intermediaries are varied: the issuer may be in a region where there is little investment activity, the issuer’s business may not be in an area favored by professionals (such as consumer electronics or software) or the issuer’s founders may be what the Notice tactfully calls 'underrepresented founders' – people of color, people without elite credentials, women and older people.” Hanks said crowdfunding can help, but that businesses in need of larger amounts of funding need to be introduced to “investors who can write larger checks” than allowed under Regulation Crowdfunding.

State members of the North American Securities Administrators Association, Inc. expressed “collective concern” about the proposed exemption and cited a specific example of how the “vast” and “opaque” private markets often produce enforcement cases that involve an “unlicensed intermediary” with victims who are often elderly persons whose retirement savings are the only reason they may qualify as accredited investors. Said NASAA: “Given the explanations described in the proposing release, it is clear that the proposal is not driven by investor protection considerations, but by a purported desire to help small businesses obtain capital. Although that is a worthy goal we all share, small business issuers will not benefit from a federal exemption in the absence of a coordinated state finder registration framework.” (In a separate comment, NASAA’s then-president urged the Commission not to advance the proposed exemption and to coordinate with state regulators).

Barbara Roper, then-Director of Investor Protection at Consumer Federation of America (and currently a member of SEC Chair Gary Gensler’s staff), stated the organization’s “strong opposition” to the proposed exemption. Although CFA said it could support the Tier I proposal, it could not support the Tier II proposal, which it said would “dramatically expand the ability of individuals to engage in a broad array of brokerage activities, in return for transaction-based compensation, without having to comply with registration and other regulatory requirements appropriate to that role.” The CFA also suggested that the SEC work with FIRNA and state regulators to develop a more tailored approach to finders.

Whether a bill like the Unlocking Capital for Small Businesses Act could ever be enacted likely depends on the willingness of its as-yet unnamed sponsor to accept changes that bring it more in line with existing SEC guidance. That was the path the M&A brokers bill took over multiple Congresses before it was finally enacted as an attachment to an appropriations omnibus.

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