Congressional Research Service
Informing the legislative debate since 1914

Capital Markets, Securities Offerings, and Related Policy Issues

Updated July 26, 2018

Congressional Research Service
https://crsreports.congress.gov
R45221

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

U.S. capital markets are the largest and considered to be the most efficient in the world. Companies rely heavily on capital access to fund growth and create jobs. As the principal regulator of U.S. capital markets, the Securities and Exchange Commission (SEC) requires that offers and sales of securities either be registered with the SEC or be undertaken with an exemption from registration. Registered securities offerings, often called *public offerings*, are available to all types of investors and have more rigorous disclosure requirements. By contrast, securities offerings that are exempt from SEC registration are referred to as *private offerings* and are mainly available to more sophisticated investors.

Some policymakers have concluded that changes in market trends require updated regulations governing capital access. Specifically, the number of publicly listed U.S. companies has declined by half over the last two decades, and small- to medium-sized companies are said to have more difficulty accessing capital relative to larger companies. Additionally, new capital access tools not previously part of the SEC regulatory regime, such as crowdfunding and initial coin offerings, have emerged. These new tools are especially helpful for small businesses and startups.

The bipartisan Jumpstart Our Business Startups Act of 2012 (JOBS Act; P.L. 112-106) scaled regulation for smaller companies and reduced regulations in general for certain types of capital formation. It established a number of new options to expand capital access through both public and private offerings, including a new provision for crowdfunding. Parts of the Fixing America's Surface Transportation Act (JOBS Act 2.0; P.L. 114-94) provided additional relief. Following the JOBS Act, the public and private offering dichotomy has started to blur, and securities regulation has become increasingly tailored to suit companies of different sizes and with different needs.

However, concerns over capital formation have persisted, given that the number of IPOs remained at far below long-term average levels post-JOBS Act and smaller businesses continue to face capital access pressure. To address these concerns, Congress has considered numerous legislative proposals to further expand the scaled approach, with some proposals building on existing JOBS Act provisions. The most notable of these proposals is S. 488, a capital formation package referred to as JOBS Act 3.0. Originally a relatively narrow bill, S. 488 was passed by the Senate and then was amended significantly and passed by the House in a 406-4 vote on July 17, 2018. The package includes 32 titles, many of which have previously passed the House with bipartisan support as standalone bills.

The policy debate surrounding capital formation proposals often focuses on expanding capital access and protecting investors, two of the SEC's core missions. Expanding capital access promotes capital formation and allows for greater access of investment opportunities for more investors. Investor protection is considered to be important for healthy and efficient capital markets because many investors would be more willing to provide capital, and even at a lower cost, if they could expect enforceable contracts for their investments through a transparent process. At times, expanding capital access can come at the expense of investor protection. For example, proposals that reduce the registration and disclosures that a company must make can decrease the company's compliance costs and increase the speed and efficiency of capital formation. But the reduced disclosures may expose a company's investors to additional risks if they are not receiving information that is important to making informed investment decisions.

This report analyzes legislative proposals that would generally affect the terms and amounts of capital provided to companies by investors. It analyzes a number of current legislative proposals and agency actions to expand both public and private securities offerings through amendments to program design, investor access, and disclosure requirements, among other provisions.

Contents

Introduction 1
Raising Capital Through Securities Offerings 3
Public Offerings 4
Private Offerings 6
Regulatory Framework for Capital Markets 7
Regulatory Entities and Approaches 7
Securities Disclosure Through Registration 8
Securities and Banking Regulation Compared 8
Policy Issues 9
Crosscutting Themes 9
Capital Formation and Investor Protection 10
A Scaled Regulatory Approach 10
Facilitating Public Offerings 13
Expansion of "IPO On-Ramp"—Emerging Growth Company Status 17
Disclosure Requirements 19
Preemption of State "Blue Sky" Laws 23
Facilitating Private Offerings 24
Investor Access to Private Offerings 26
"Mini-IPO"—Regulation A+ 28
Micro Offering 31
Facilitating Fintech Offerings 32
Securities-Based Crowdfunding 33
Initial Coin Offerings 37

Figures

Figure 1. Financing of Nonfinancial Companies, 2016 1
Figure 2. Number of U.S.-Listed Public Companies and Aggregate Market Capitalization 13
Figure 3. Pre-JOBS Act IPO Trends 14
Figure 4. Public and Private Capital Raised by U.S. Companies (2009-2017) 16
Figure 5. Post-JOBS Act Emerging Growth Company Trends 18
Figure 6. Aggregate Capital Raised in Securities Markets by Offering Methods 25
Figure 7. Aggregate Capital Raised in Qualified Regulation A Offerings 29
Figure 8. Stock Performance of Publicly Listed Regulation A+ Companies 30
Figure 9. Examples of Rapid Stock Price Increases on ICO- and Blockchain-Related Announcements 40

Tables

Table 1. Comparison of Key Securities Offerings 12

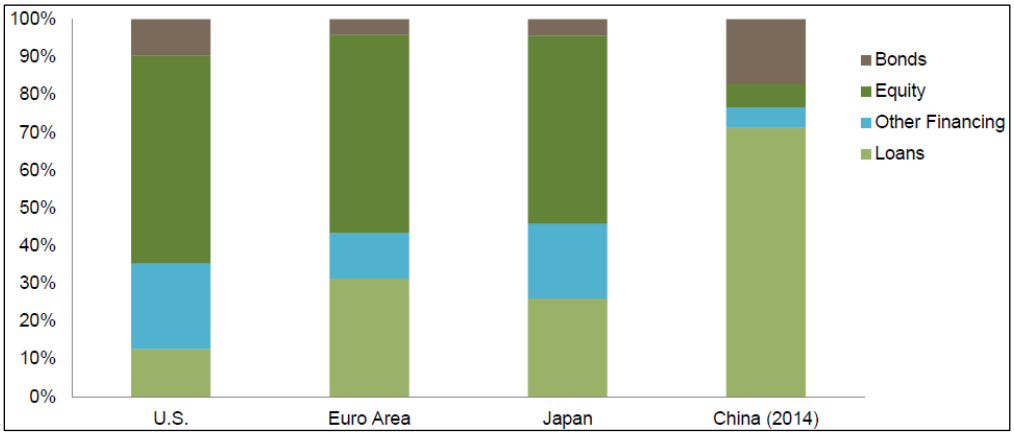
Contacts

Author Information..... 43

Introduction

Companies turn to a variety of sources to access the funding they need to grow. Capital markets are the largest source of financing for U.S. nonfinancial companies, representing 65% of all financing for such companies in 2016 (**Figure 1**).[1] Capital markets are segments of the financial system in which funding is raised through equity or debt securities.[2] Equity, also called stocks or shares, refers to ownership of a firm. And debt, such as bonds, refers to the indebtedness or creditorship of a firm. In addition to capital markets, companies obtain funding from bank loans (13%) and other financing (23%).[3]

Figure 1. Financing of Nonfinancial Companies, 2016



Sources: Securities Industry and Financial Markets Association (SIFMA), Organisation for Economic Co-operation and Development, European Central Bank, Bank of Japan, National Bureau of Statistics of China. SIFMA, *U.S. Capital Markets Deck*, September 2017, at https://www.sifma.org/wp-content/uploads/2016/10/US-Capital-Markets-Deck-2017-09-11-SIFMA.pdf.

Notes: "Bonds" and "equity" include both public and private offerings. "Loans" include all bank financing. "Other financing" includes insurance reserves, pension reserves, trade credit, and other accounts payable.

U.S. capital markets are considered the deepest and most liquid in the world. U.S. companies are more reliant on capital markets for funding than companies in the euro area, Japan, or China, which rely more on bank loans (see **Figure 1**).[4]

[1] Data provided by SIFMA.

[2] A more detailed definition of securities could be found through the Howey test. In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court set forth the foundational test for whether a transaction qualifies as a form of security known as an "investment contract." Under *Howey*, an investment contract is (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others. See also *SEC v. Edwards*, 540 U.S. 389, 393 (2004). Rahul Mukhi and James Michael Blakemore, Cleary, Gottlieb, Steen & Hamilton LLP, "SEC Cyber Unit and Allegedly Fraudulent ICO," December 26, 2017, at https://corpgov.law.harvard.edu/2017/12/26/sec-cyber-unit-and-allegedly-fraudulent-ico.

[3] Some may argue that support from family, friends, and personal finances, generally referred to as "bootstrapping," is also a form of funding for start-ups. Because of data limitations, bootstrap activities are not discussed in this report. Ryan Smith, "Why Every Startup Should Bootstrap," *Harvard Business Review*, March 2, 2016, at https://hbr.org/2016/03/why-every-startup-should-bootstrap.

[4] SIFMA, *U.S. Capital Markets Deck*, September 2017, at https://www.sifma.org/wp-content/uploads/2016/10/US-Capital-Markets-Deck-2017-09-11-SIFMA.pdf.

Access to capital allows businesses to fund their growth, to innovate, to create jobs, and to ultimately help raise society's overall standard of living. Given the importance of U.S. capital markets and their role in allocating funding, issues affecting the markets generally warrant policy attention. Some of the most discussed recent trends include the decline in the number of public companies and the increased tendency of public capital to concentrate in larger companies. In addition, there are indications that private capital—which has less regulation and information disclosure—is growing in usage. Also of concern is the emergence of financial technology that both enables new methods of capital formation and poses significant regulatory challenges.

To address some of the trends mentioned above, Congress passed the Jumpstart Our Business Startups Act of 2012 (JOBS Act; P.L. 112-106; see text box below), which established a number of new options for expanding capital access especially for smaller companies. As discussed later in this report, some of the changes made by the JOBS Act have been successful in facilitating capital formation, but in other areas the same concerns remain. In response, the 115th Congress has considered many proposals to boost capital markets, including S. 488, a capital formation package that consists of 32 titles that have mostly already passed the House with bipartisan support as standalone bills.[5] Originally a relatively narrow bill, S. 488 was passed by the Senate before being amended significantly and passed by the House. The package has been referred to as JOBS Act 3.0, taking into account the initial JOBS Act in 2012 and the financial services provisions signed into law as part of the Fixing America's Surface Transportation Act (P.L. 114-94; parts of which are referred to as JOBS Act 2.0). Seven provisions in S. 488 are discussed in this report and were previously introduced as standalone legislation: H.R. 1585, H.R. 1645, H.R. 3903, H.R. 3972, H.R. 5970, H.R. 6324, and H.R. 6380.

This report provides background and analysis on proposals related to capital formation through the two main ways of raising capital—public and private offerings—and the regulatory environment in which they operate.[6] The report also explores key policy issues and their connection to legislative discussions. It provides general background for more than a dozen current legislative proposals, allowing for discussion of each proposal within its own policy context as well as providing a framework for viewing the proposals in aggregate. For easy navigation, legislative proposals are highlighted in text boxes within each relevant policy issue section.

[5] House Financial Services Press Release, "House Passes Bipartisan 'JOBS & Investor Confidence Act'," July 17, 2018, at https://financialservices.house.gov/news/email/show.aspx?ID=7UD3NQFEEE64BPYFPVE5Z6WSBQ.

[6] This report focuses on primary markets, the markets in which securities are initially issued. The secondary market is where the securities issued in the primary market are traded.

Jumpstart Our Business Startups Act (JOBS Act; P.L. 112-106)

The JOBS Act was designed to reduce regulatory burdens on certain types of capital formation, especially for smaller companies. As a legislative response to the slow growth coming out of the 2007-2009 recession, the act was passed with bipartisan support in 2012.

The JOBS Act established a number of new options to expand capital access through both public and private offerings. For example, it established the IPO On-Ramp as a scaled-down version of a standard initial public offering (IPO) for smaller companies. It also expanded access to existing private offerings traditionally serving smaller companies' funding needs—for example, the expansion of capital access through Regulation A+, the Threshold Rule, and Regulation D. The JOBS Act also established a new type of offering for crowdfunding. Some of these program changes have already generated significant issuer participation and impact. Much of the specifics of the JOBS Act are discussed in the relevant sections of this report.

Though signed into law in 2012, it took several years to implement the JOBS Act. Effective implementation dates for JOBS Act provisions were as follows:

- Title I Emerging Growth Company (IPO On-Ramp): April 5, 2012
- Title II Regulation D General Solicitation: September 23, 2013
- Title III Regulation Crowdfunding: May 16, 2016
- Title IV Regulation A+ (Mini-IPO): June 19, 2015

Raising Capital Through Securities Offerings

As the principal regulator of U.S. capital markets, the Securities and Exchange Commission (SEC) requires that offers and sales of securities—whether debt or equity—either be registered with the SEC or be undertaken with an exemption from registration.[7] Companies seeking funding through securities offering are referred to as *issuers*. Registered offerings, often called *public offerings*, are available to all types of investors and are not limited in the amount of funds that can be raised or resold. Registered offerings include a significant amount of disclosure about the company (the issuer), its financial status, and the funds that are being raised. A key attribute of public securities offerings is investors' ability to resell the securities on public secondary markets through national exchanges to all investor types.[8] By contrast, securities offerings that are exempt from SEC registration are referred to as *private offerings*, *private placements*, or *unregistered offerings*. They are mainly available to those perceived to be more sophisticated financial institutions or individual investors thought to be better positioned to absorb the risk and make informed decisions with the reduced information disclosed in a private offering. Because of the restrictions on who may purchase them, private offerings generally do not trade on stock exchanges. In general, private offerings provide firms with more control over their internal affairs and lower compliance costs, whereas public offerings provide broader access to potential investors.

[7] The Securities Act of 1933 (Securities Act; P.L. 73-22) and the Securities Exchange Act of 1934 (Exchange Act; P.L. 73-291) regulate the offers and sales of securities. The Securities Act requires companies to go through the SEC registration process for securities offerings. It also provides exemptions to permit securities offers and sales without SEC registration. The Exchange Act requires companies having effective registration statements to file periodic ongoing reports or other information with the SEC. For more detail, see SEC, *Registration Under the Securities Act of 1933*, at https://www.sec.gov/fast-answers/answersregis33htm.html; *Exchange Act Reporting and Registration*, at https://www.sec.gov/smallbusiness/goingpublic/exchangeactreporting; and *Federal Securities Laws*, at https://www.sec.gov/page/federal-securities-laws?auHash=B8gdTzu6DrpJNvsGlS1-JY1LnXDZQqS-JgJAgaSXimg.

[8] A limited-scale secondary market also exists for private offerings. Nasdaq Private Market and SharesPost, for example, can both trade private securities, but would have to confirm accredited investor status for each transaction.

Public Offerings

Public offerings consist of initial public offerings (IPOs), the first time a company offers its shares of stock to the general public in exchange for cash, and subsequent public offerings. The IPO process, which is the source of much of the policy debate surrounding public offerings, is commonly regarded as the turning point for companies "going public." By going public, a company's shares can be owned by the public at large rather than just by the original owners, venture capital funds, and the relatively small pool of those perceived to be more sophisticated investors. SEC registration, which is a key requirement for going public, enables public disclosure of key company financial information.[9] Companies may choose to go public to access capital that would allow founders to cash out their investments, to provide substantial stock and stock options[10] to employees and through management incentive plans, and to fuel the company's future growth. Public companies may also benefit from a "liquidity premium," which translates into better share pricing compared with stock from comparable private offerings.[11] Other potential benefits include publicity and brand awareness.[12]

There are also a number of drawbacks to going public. From an issuer's perspective, two of the most discussed drawbacks are compliance costs and certain changes to business operations.

- **Compliance Costs.** Some believe the costs of registration are disproportionately burdensome for small and medium-sized businesses, including startup firms. The direct costs include underwriting, external auditing, legal fees, and financial reporting fees.
- **Business Operations.** Public companies are often perceived to face incremental market pressure to perform well over the short term, to reduce insider control and decisionmaking flexibility, and to contend with increased shareholder activism (which sometimes can benefit a firm financially). Some research has indicated that going public can adversely affect corporate innovation; however, there are also many examples of innovative public companies.

Initial Public Offering

An IPO is the first time a company offers its shares of capital stock to the general public.[13] An IPO gives the investing public the opportunity to own and participate in the growth of a formerly private company. The process begins with the company's selection of underwriters, lawyers, and accountants to prepare for the issuance of the securities, and, along with the company's top executives, they form an IPO working group. The process generally consists of three phases.

Prefiling Period. As part of an IPO, a company must file a registration statement and other documents that contain information about the company and the funds it is attempting to raise. During the prefiling period, the public filings are prepared and the planning begins with a thorough review of the company's operations, procedures, financials, and management, as well as

[9] SEC, "How Can My Small Business Raise Capital?" *Small Business and the SEC*, at https://www.sec.gov/reportspubs/investor-publications/infosmallbusqasbsechtm.html.

[10] A stock option is a privilege but not an obligation to buy or sell a stock at an agreed-upon price within a certain period of time.

[11] Liquidity premium refers to the additional yield on a financial asset the investors would demand if such investment cannot be easily converted to cash through trading in a timely manner or at its perceived fair market value.

[12] SEC, *Should My Company 'Go Public'*?, at https://www.sec.gov/smallbusiness/goingpublic/companygoingpublic.

[13] SEC Investor Bulletin, *Investing in an IPO*, at https://www.sec.gov/investor/alerts/ipo-investorbulletin.pdf.

its competitive positioning and business strategy.[14] The disclosure documents serve the dual purpose of satisfying SEC registration requirements and communicating with investors.[15]

Waiting Period. Once the key disclosures are filed, the company waits for the SEC to review and provide approval of its draft registration statements. The company then concurrently addresses SEC comments and prepares roadshow presentations as well as legal documents. Roadshows are presentations made by an issuer's senior management to market the upcoming securities offering to prospective investors. Roadshows can commence only after the filing of registration statements because Section 5(c) of the Securities Act prohibits public offers of securities prior to the filing of a registration statement.[16]

Posteffective Period. The actual sales to investors take place after the SEC declares that the IPO registration is effective. The posteffective period extends from the effective date of the registration statements to the completion of distribution of the securities.[17] With the completion of the IPO, a security generally continues to trade on a stock exchange.

IPO On-Ramp and Emerging Growth Company

Title I of the JOBS Act established streamlined compliance options for companies that meet the definition of a new type of issuer, called an emerging growth company (EGC).[18] The streamlined process available to an EGC is also referred to as the "IPO On-Ramp," because it is a scaled-down version of a traditional IPO. This new process reduces regulatory requirements for companies to go public.

To qualify as an EGC, an issuer must have total annual gross revenues of less than $1 billion during its most recently completed fiscal year.[19] EGCs maintain their status for five years after an IPO or when their gross revenue exceeds $1 billion, whichever occurs first, among other conditions. Relative to a standard IPO, EGCs' IPOs can take advantage of the following forms of relief:[20]

- Scaled disclosure requirements in which EGCs (1) need to provide two years of financial statements certified by independent auditors, instead of three years for a traditional IPO; and (2) are not required to provide compensation committee reports, among other things.
- EGCs are exempted from auditor attestations of internal control over financial reporting that are required by Sarbanes-Oxley Act Section 404(b).[21]

---

[14] The goal of the due diligence review is to independently investigate and verify information about the company and its business to ensure the information contained in the registration statement is accurate and that the registration statement includes all information about the company's business, operations, financial condition, and prospects that would be material to investors. Thomas France, "How to Manage the Due Diligence Process for an IPO," *Law360*, September 2013, at https://www.law360.com/articles/475791/how-to-manage-the-due-diligence-process-for-an-ipo.

[15] *NYSE IPO Guide, Second Edition*, 2013, Caxton Business & Legal, Inc.

[16] Craig F. Arcella, Cravath, Swaine & Moore LLP, "The Nuts and Bolts of Roadshows," at https://www.cravath.com/files/Uploads/Documents/The%20Nuts%20and%20Bolts%20of%20Road%20Shows%20%285-502-2419%29.pdf.

[17] Gibson Dunn, *IPO Guidebook*, at https://www.gibsondunn.com/wp-content/uploads/2018/01/CAP-IPO-Guidebook.pdf.

[18] P.L. 112-106.

[19] SEC, "Generally Applicable Questions on Title I of the JOBS Act," at https://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

[20] Ibid.

[21] For more details on Sarbanes-Oxley and auditing regulation, see CRS Report R44894, *Accounting and Auditing*

- "Test-the-waters" communications mean EGCs may meet with qualified institutional buyers and institutional accredited investors to gauge their interest in a potential offering during the registration process, an activity prohibited during a normal IPO.[22]
- A confidential SEC review process allows companies to submit draft registration statements to the SEC for a confidential review prior to making the filings public. While initially limited to EGCs, the SEC expanded this benefit to all companies as of July 10, 2017.

Whereas the first two compliance-related forms of relief would appear to generate cost savings for all EGC status holders, the test-the-waters and confidential review features may be especially valuable for companies in industries where valuation is uncertain and the timing of the IPO depends on regulatory or other approval (e.g., the biotech and pharmaceutical industries).[23] The ability to submit confidentially and to "test-the-waters" with prospective investors can provide additional flexibility to company issuers. EGCs that take advantage of these can either continue the IPO process or withdraw after receiving feedback from the SEC and prospective investors, prior to making public disclosures.

Following the SEC's expansion of the confidential review option to all companies, most companies now use the process to incorporate feedback prior to public disclosure and announcement. IPO processes that used to take up to seven months from announcement to trading now take less than 50 days, with the reduced time due mostly to shifting of the review time to prior to announcements.[24]

Private Offerings

Both public and private companies could conduct private offerings to offer or sell securities in accordance with registration exemptions under the Securities Act. To raise capital through a private offering, a company must use one of the key registration exemptions under federal securities laws, including the following:

- **Regulation D**[25] is the most frequently used exemption to sell securities in unregistered offerings. Companies relying on a Regulation D exemption do not need to register their offerings with the SEC, but they face limitations regarding investor type and resale restrictions of their offerings.[26] Regulation D includes two SEC rules—Rules 504 and 506, which provide different maximum offering amounts, among other conditions.[27]

Regulatory Structure: U.S. and International, by Raj Gnanarajah.

[22] The communications could take place either before or after the registration.

[23] Latham & Watkins, *The JOBS Act, Two Years Later: An Update Look at the IPO landscape*, April 2014, at https://www.lw.com/thoughtLeadership/lw-jobs-act-ipos-second-year.

[24] Brandon Kochkodin, "IPO Timelines Are Cut by 80% After SEC's Private Filing Decision," *Bloomberg*, December 2017, at https://www.bloomberg.com/news/articles/2017-12-22/ipo-timelines-are-cut-by-80-after-sec-s-private-filing-decision; and SEC, "SEC's Division of Corporation Finance Expands Popular JOBS Act Benefit to All Companies," press release, June 2017, at https://www.sec.gov/news/press-release/2017-121.

[25] 17 C.F.R. §§230.501 et seq.

[26] SEC, *Regulation D Offerings*, at https://www.sec.gov/fast-answers/answers-regdhtm.html.

[27] Regulation D Rule 505 was repealed effective May 22, 2017. 17 C.F.R. §§200, 230, 239, 240, 249, 270, and 275, at https://www.sec.gov/rules/final/2016/33-10238.pdf; SEC Investor Bulletin, *Private Placements Under Regulation D*, at https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/investor-bulletin-private-placements-under.

- **Regulation A**[28] facilitates capital access for small to medium-sized companies. It has fewer disclosure requirements than the conventional securities registration process. Due to the JOBS Act, Regulation A was updated in 2015 with a two-tiered structure (Regulation A+) to exempt from registration offerings of up to $50 million annually, if specified requirements are met.[29]
- **Regulation Crowdfunding**[30] permits companies to offer and sell securities through crowdfunding, which generally refers to the use of the internet by small businesses to raise capital through limited investments from a large number of investors.[31]
- **Rule 144A**[32] is for resale transactions only. Issuers generally use it in a two-step process to first facilitate an offering on an exempt basis to financial intermediaries, and then resell to qualified institutional buyers, or QIBs (corporations deemed to be accredited investors).[33]
- **Rule 147A**[34] permits companies to raise money from investors within their home state by registering at the state level, without concurrently having to register the offers and sales at the federal level.[35]

Regulatory Framework for Capital Markets

Regulatory Entities and Approaches

U.S. capital markets are mainly regulated by the Securities and Exchange Commission (SEC), state securities regulators, self-regulatory organizations (SROs), and the Commodity Futures Trading Commission (CFTC), which generally regulates derivatives markets.[36]

As the principal regulator of capital markets, the SEC is responsible for overseeing significant parts of the nation's securities markets and certain primary participants such as broker-dealers, investment companies, investment advisors, clearing agencies, transfer agents, credit rating agencies, and securities exchanges, as well as SROs such as the Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and Public Company Accounting Oversight Board (PCAOB).[37]

---

[28] 17 C.F.R. §§200, 230, 232, 239, 240, 249, and 260.

[29] SEC, *Investor Bulletin: Regulation A*, at https://www.sec.gov/oiea/investor-alerts-bulletins/ib_regulationa.html.

[30] 17 C.F.R. §§200, 227, 232, 239, 240, 249, 269, and 274.

[31] FINRA Investor Alerts, "Updated: Crowdfunding and the JOBS Act: What Investors Should Know," May 17, 2017, at http://www.finra.org/investors/alerts/crowdfunding-and-jobs-act-what-investors-should-know; and SEC, *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers*, May 13, 2016, at https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm.

[32] 17 C.F.R. §230.144.

[33] SEC, *Rule 144: Selling Restricted and Control Securities*, January 16, 2013, at https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html.

[34] 17 C.F.R. §§200, 230, 239, 240, 249, 270 and 275.

[35] SEC, "SEC Adopts Final Rules to Facilitate Intrastate and Regional Securities Offerings," press release, October 26, 2016, at https://www.sec.gov/news/pressrelease/2016-226.html.

[36] For more details, see CRS Report R43117, *The Commodity Futures Trading Commission: Background and Current Issues*, by Rena S. Miller.

[37] Under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (P.L. 111-203) Titles VII, IX, and

The SEC uses a combination of rules, enforcement, and examinations to construct a three-pronged regulatory approach that focuses on (1) disclosure-based rules, (2) an antifraud regime, and (3) rules governing securities market participants (for example, exchanges, broker-dealers, and investment advisors).[38]

Securities Disclosure Through Registration

One of the cornerstones of securities regulation—the Securities Act of 1933—is often referred to as the "truth in securities" law.[39] As the phrase suggests, disclosures pertaining to securities allow investors to make informed judgments about whether to purchase specific securities by ensuring that investors receive financial and other significant information on the securities being offered for public sale. The SEC does not make recommendations as to whether to invest.[40] The disclosure-based regulatory philosophy is consistent with Supreme Court Justice Louis Brandeis's famous dictum that "sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[41]

As mentioned previously, the types of disclosure vary based on whether a company is making a public or private offering. For public companies, the registration process requires companies to file with the SEC essential facts, including financial statements certified by independent accountants, information about the management of the company, a description of the security to be offered for sale, and a description of the company's properties and business.[42] Registration statements generally become public shortly after the company files them with the SEC. As such, registering an offering with the SEC would make a company a public company.[43] Private offerings also involve a registration process, but the process is scaled back, and these offerings are generally limited to more sophisticated investors who are perceived as better positioned to comprehend or tolerate the risks associated with less disclosure.

For more on disclosure, see the "Disclosure Requirements" section of this report.

Securities and Banking Regulation Compared

Capital market regulation differs from banking regulation in its regulatory philosophy and structural setup. Stocks, bonds, and other securities are not guaranteed by the government and can lose value for investors. As such, the SEC's primary concerns are promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud.[44] This is designed to help investors make informed investment decisions. Although the SEC requires that the information provided be accurate, it does not guarantee it. Investors who

---

XVI, SEC's jurisdiction also expanded to include certain participants in the derivatives markets, private fund advisers, and municipal advisors.

[38] SEC Chairman Jay Clayton, "Remarks at the Economic Club of New York," July 12, 2017, at https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[39] 15 U.S.C. §§77a et seq.

[40] SEC, *Registration Under the Securities Act of 1933*, at https://www.sec.gov/fast-answers/answersregis33htm.html.

[41] Louis Brandeis, "What Publicity Can Do," Chapter 5 in *Other People's Money* (1932). First published in *Harper's Weekly*, December 20, 1913.

[42] Ibid.

[43] SEC, "How Can My Small Business Raise Capital?" *Small Business and the SEC*, at https://www.sec.gov/reportspubs/investor-publications/infosmallbusqasbsechtm.html.

[44] SEC, "What We Do," at https://www.sec.gov/Article/whatwedo.html; SEC, *Agency and Mission Information*, at https://www.sec.gov/about/reports/sec-fy2017-agency-mission-information.pdf.

purchase securities and suffer losses have recovery rights if they can prove incomplete or inaccurate disclosure of important information.

Banking regulation's prudential regulatory approach, on the other hand, emphasizes risk control and mitigation for the safety and soundness of individual institutions as well as the financial system as a whole.[45] One rationale behind banking regulation is that, because bank deposits are guaranteed by the federal government, banks may have an incentive to take additional risks that they would not take in the absence of insurance on deposits. The government examines the operations of banks to safeguard taxpayer money and ensure that banks are not taking excessive risks.

These two different approaches have led to different agency designs and budget allocations. For example, banking regulators are heavily focused on examination programs that closely monitor and oversee financial institutions' operations and risk mitigation methods. One of the major banking regulators, the Federal Deposit Insurance Corporation, allocates half of its annual budget toward mostly examination-based supervision and consumer protection programs.[46] SEC regulation, in contrast, relies less on examinations.[47] The SEC cedes certain examinations to SROs like FINRA and focuses its own examinations on selected priority areas, instead of a broader examination coverage of all securities issuers.[48]

Policy Issues

Some in Congress have called for modifying capital market regulations to make it easier for companies to raise capital. They argue that the existing regulatory structure unnecessarily restricts access to capital markets, making it more difficult for companies to grow and create jobs. Others have argued that certain approaches to expanding capital market access could put investors at risk of making uninformed decisions or becoming victims of fraud and other abuses.

This section analyzes key policy issues in public and private capital markets and assesses proposals to facilitate access to capital in each segment. In addition, emerging financial technology ("fintech") issues related to crowdfunding and initial coin offerings are also analyzed.

Crosscutting Themes

For many of the proposals discussed below, two themes apply—the relationship between capital formation and investor protection, and a scaled regulatory approach. The section starts with an explanation of each.

---

[45] For more on prudential regulation, see Federal Reserve Bank Atlanta President Dennis Lockhart, "Thoughts on Prudential Regulation of Financial Firms," March 2015, at https://www.frbatlanta.org/news/speeches/2015/150320-lockhart.aspx; and Federal Reserve Board Chair Janet Yellen, "Supervision and Regulation," September 2016, at https://www.federalreserve.gov/newsevents/testimony/yellen20160928a.htm.

[46] The FDIC considers examination to be the core of its supervisory program. For more details on FDIC budget allocation, see *FDIC Annual Report 2016*, at https://www.fdic.gov/about/strategic/report/2016annualreport/2016ar_final.pdf.

[47] SEC's examination unit, the Office of Compliance Inspections and Examination, on the other hand, cost $349 million in FY2016, representing 22% of SEC's $1.6 billion total budget for the year. SEC, *U.S. Securities and Exchange Commission, Fiscal Year 2018 Congressional Budget Justification, Annual Performance Plan, and Fiscal Year 2016 Annual Performance Report*, at https://www.sec.gov/files/secfy18congbudgjust.pdf.

[48] SEC, "SEC Office of Compliance Inspections and Examinations Announces 2018 Examination Priorities," press release, February 7, 2018, at https://www.sec.gov/news/press-release/2018-12.

Capital Formation and Investor Protection

The policy debate surrounding efforts to promote capital access illustrates the perceived tradeoffs between investor protection and capital formation, two of the SEC's statutory mandates. Expanding capital access promotes capital formation and arguably "democratizes" capital markets by allowing for greater access to investment opportunities for more investors. Investor protection is considered to be important for healthy and efficient capital markets because some research suggests that investors would be more willing to provide capital, and even at a lower cost, if they have faith in the integrity and transparency of the underlying markets.

Maintaining a balance between these two goals can pose challenges for policymakers. For example, capital formation needs may be better met if issuers could choose their preferred methods of fundraising without regard to SEC registration. This is because the registration process raises the costs of accessing securities markets, which could potentially deter investment activities and reduce funding to businesses. At the same time, the reduced disclosure may expose retail investors of limited financial means to additional risks if they are not aware of key risk factors prior to making investment decisions (see "Investor Access to Private Offerings" for a discussion of "accredited investors").

A Scaled Regulatory Approach

The relationship between public and private offerings used to be more clearly defined; registration requirements were generally more substantial for public offerings than for private offerings prior to the 2012 JOBS Act. The public and private offering dichotomy started to blur following the JOBS Act, offering a more scaled regulatory approach. The act created a number of "hybrid" offerings that incorporate design features of both public and private offerings. The most obvious example is Regulation A+, a private offering that could potentially trade on public exchanges to a greater extent. As such, capital access regulation is less "one size fits all" than before, though the debate about whether regulation has been appropriately tailored is ongoing.

Table 1 highlights a number of key attributes that determine each securities offering's capital access capacity. These attributes should not be viewed in isolation, as they work together to form a holistic design for meeting each offering's policy goal. Below are examples of key attributes of major offering programs.

- **Maximum Offering Amount.** This is the upper limit of the offering program. For example, Regulation Crowdfunding currently has a size limit of around $1 million for any given year, limiting the program to smaller firms. In contrast, public offerings have no maximum amount, but issuers must undergo full disclosure.
- **Filing Requirements.** As mentioned previously, disclosure is at the core of securities regulation and is also the dividing point between public and private offerings.[49] Generally, a higher level of disclosure (which may be associated with

[49] Under federal securities laws, a company may not offer or sell securities unless the offering has been registered with the SEC or an exemption from registration is available. Generally speaking, private offerings are not subject to some of the laws and regulations that are designed to protect investors, such as the comprehensive disclosure requirements that apply to registered offerings (i.e., public offerings). As such, the registration and disclosure process is considered the dividing point between public and private offerings. SEC Investor Bulletin, *Private Placements Under Regulation D*, September 2014, at https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html.

higher costs) leads to larger offering size limits and broader investor access, as well as reduced resale restrictions.

- **Nonaccredited Investor Access.** This attribute limits the kinds of investors allowed to participate in an offering. Generally, the higher the amount of disclosure, the more open an offering is to nonaccredited investors, who are perceived as less sophisticated.[50]
- **Resale Restrictions.** *Resale* pertains to owners of securities transferring ownership to others for cash. Resale restrictions determine whether the instruments could enter secondary markets.[51] Resale capability is a given for publicly traded shares, but for private offerings, resale is generally restricted. For example, the private offering with the largest volume—Regulation D—faces resale restrictions, meaning investors have fewer exit options.
- **Preemption of State Registration or Qualification.** States impose certain securities regulations concurrent with SEC regulations.[52] Certain offering programs—for example, Regulation A-Tier 1—face requirements to register securities with the states, which have regulatory responsibility and expertise over small and local securities. This could be challenging and costly for issuers if the offering operates in multiple states, each with different registration requirements. In contrast, Regulation A-Tier 2, Regulation D-Rule 506, and Regulation Crowdfunding preempt state laws.

The various attributes are structured so as to create a relatively tailored system in which smaller companies have available to them less burdensome approaches to raising capital. In a 2017 public speech, SEC Chairman Jay Clayton emphasized the importance of a scaled regulatory approach in securities regulation.

> Recently, Congress and the SEC have taken significant steps to further develop a capital formation ecosystem that includes a scaled disclosure regime. Now, for example, a small company may begin with a Regulation A mini-public offering of up to $50 million, then move to a fully registered public offering as a smaller reporting company (EGC), and eventually develop into a larger, more seasoned issuer (Full-disclosure IPO). This is a potentially significant development and I believe there remains room for improving our approach to the regulation of capital formation over the life cycle of a company—to be clear, improvements that also serve the best interests of long-term retail investors.[53]

Reflecting the same consideration for companies of different sizes and needs, the 115th Congress is considering a number of legislative proposals to further expand this scaled approach, building on existing JOBS Act measures. Many of the proposals either modify the attributes listed in **Table 1** so as to expand a particular type of offering or to create new types of offerings. Examples of these proposals are presented in text boxes throughout the remainder of this report.

---

[50] See the "Policy Issues" section of this report for a more detailed discussion of accredited investors.

[51] The primary market is where securities are created, and the secondary market is where securities are traded. The secondary market is essential for obtaining financial asset liquidity.

[52] See the "Policy Issues" section of this report for a more detailed discussion of state blue sky laws.

[53] SEC Chairman Jay Clayton, "Remarks to the Annual Government-Business Forum on Small Business Capital Formation," November 30, 2017, at https://www.sec.gov/news/public-statement/annual-government-business-forum-small-business-capital-formation.

Table 1. Comparison of Key Securities Offerings

Types of Securities Offerings	Maximum Offering Amount	Key Filing Requirements	Nonaccredited Investor Access	Resale Restrictions or Limitations	Preemption of State Registration
Public Offering	No limit	Full SEC registration requirements, including, but not limited to, Regulation S-K (nonfinancial disclosure), S-X (financial disclosure), and S-T (electronic filing regulations).	Full Access	No	Yes
IPO On-Ramp	No limit, but subject to EGC status eligibility	Scaled-down SEC registration, including test-the-waters provisions, two years rather than three years of audited financial statements, and certain reduced executive compensation disclosure provisions, among others.	Full Access	No	Yes
Regulation A-Tier 1	$20 million within 12 months	Form 1-A (an offering circular that contains information about the offering and the related risks, use of proceeds, business description and financial statements, among other things). Financial statements disclosed in a Tier 2 offering have to be audited, whereas Tier 1 offering financial statements could be unaudited.	Full Access	No	No
Regulation A-Tier 2 (Mini-IPO)	$50 million within 12 months		Nonaccredited investors subject to investment limits	No	Yes
Regulation Crowdfunding	$1,070,000 within 12 months	Form C (include two years of financial statements that are certified, reviewed, or audited, as required). Scaled disclosure requirements for offerings of $107,000 or less, $107,000-$535,000, and more than $535,000.	Does not specify accredited investor status, but subject to a range of investor income, net worth, and investment amount limitations	Yes	Yes
Regulation D-Rule 504	$5 million within 12 months	Form D (a brief four-page notice that generally includes only the names and addresses of key personnel and some details about the offering).	Full Access	Yes	No
Regulation D-Rule 506	No limit		No more than 35 sophisticated but nonaccredited investors - 506(b)	Yes	Yes

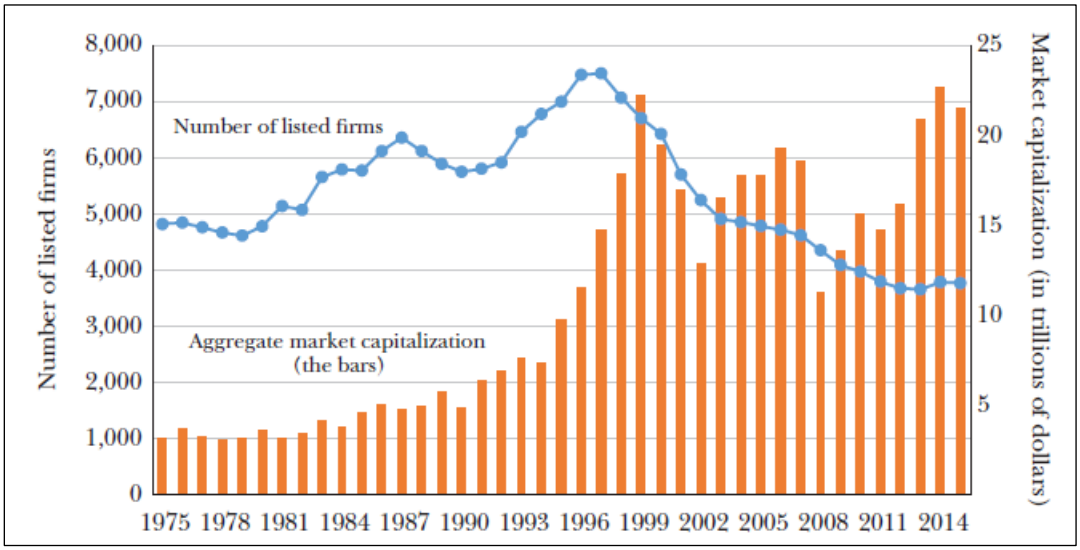
Source: CRS, based on SEC reporting.

Note: The descriptions in the table apply to general conditions only; they are not inclusive of all conditions and exceptions.

Facilitating Public Offerings

Once a company goes through SEC registration and public disclosure, it is generally referred to as a public company. A public offering was traditionally viewed as a significant funding source for growing companies, but its importance has generally deteriorated in the last two decades. The number of U.S.-listed domestic public companies has declined by half from the previous peak in the mid-1990s, as seen in **Figure 2**, whereas listings rose by half in other developed countries over the same time period.[54] According to data provider Dealogic, U.S. IPOs raised $49.3 billion through 189 offerings in 2017, more than double 2016's level of $24.2 billion raised through 111 offerings.[55] Nevertheless, 2017's number of IPOs remains far below the pre-1999 average of 547 IPOs per year (**Figure 3**), though there is some debate as to whether the period around the dot-com bubble of the late 1990s is the best comparison.

Figure 2. Number of U.S.-Listed Public Companies and Aggregate Market Capitalization



Source: Center for Research in Security Prices and Kathleen M. Kahle and René M. Stulz, "Is the U.S. Public Corporation in Trouble?" *Journal of Economic Perspectives*, vol. 31, no. 3 (2017), pp. 67-88, at http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.31.3.67.

Notes: Number of listed firms by year on the NYSE, Nasdaq, and Amex, and market capitalization from 1975 to 2015; market capitalization in 2015 dollars.

The companies that fundraise through public offerings are increasingly large companies. The average size of public companies has grown four-fold between 1996 and 2017. As of early 2017, more than half of all U.S. market capitalization[56] was held by around 140 companies with $50 billion or more in market value. Around 29% of total market capitalization was held by the largest

[54] Craig Doidge, G. Andrew Karolyi, and René M. Stulz, *The U.S. Listing Gap*, *Journal of Financial Economics*, vol. 123, no. 3 (March 2017), pp. 464-487, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2605000.

[55] Maureen Farrell and Corrie Driebusch, "Hoping for an Avalanche of Huge IPOs in 2018? Get Ready to Keep Waiting," *Wall Street Journal*, January 2, 2018, at https://www.wsj.com/articles/hoping-for-an-avalanche-of-huge-ipos-in-2018-get-ready-to-keep-waiting-1514808000.

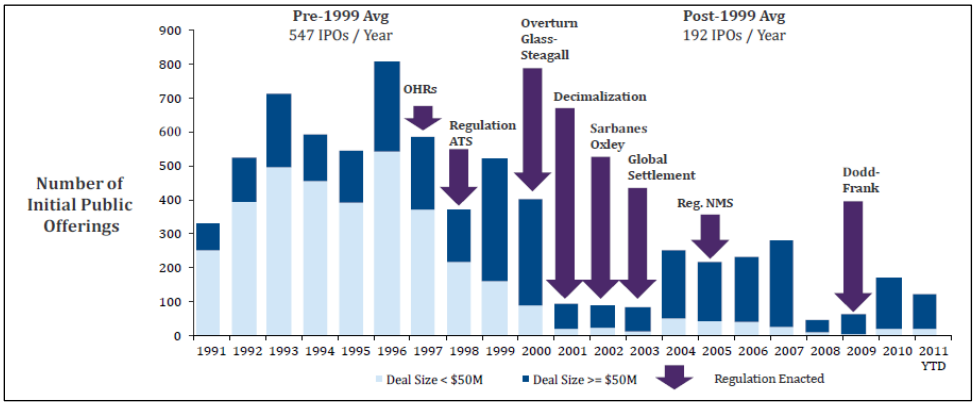
[56] Market capitalization refers to the market value of a company. It is measured by multiplying the company's share price with the number of shares outstanding.

1% of public companies. The average market capitalization of a U.S.-listed company was $7.3 billion as of early 2017, compared to $1.8 billion (inflation adjusted) in 1996.[57] In addition, aggregate market capitalization in 2014 and 2015 remained close to the all-time high (**Figure 2**). These trends indicate that although the absolute number of publicly listed companies has decreased, their average size has increased (through mergers, acquisitions, organic growth, or delisting of smaller public companies), aggregating to a total market capitalization that has showed no signs of decline in recent years.

Research indicates that smaller-company IPOs were down substantially prior to the JOBS Act (**Figure 3**), and that smaller firms are particularly likely to experience losses and earn lower returns.[58] Following enactment of the JOBS Act, smaller companies' relative difficulty accessing capital through public offerings improved somewhat through the EGC program (as discussed in the "Expansion of "IPO On-Ramp"—Emerging Growth Company Status" section of this report). However, some argue that the total number of IPOs has not increased significantly following enactment of the JOBS Act and is still below its long-term average, suggesting that improvements are not meaningfully reflected in the number of IPOs.

Figure 3. Pre-JOBS Act IPO Trends

Smaller IPOs Decreased Significantly



Sources: JMP Securities, Dealogic, Capital Markets Advisory Partners, and Grant Thornton.

Although there is a general consensus that regulatory relief could reduce entry barriers and the costs of going public, disagreement persists regarding the nature of the decline in the number of IPOs and whether the issue warrants regulatory intervention.[59] Some argue that companies' decisions to shift from public offerings to private offerings are a structural change within the economy that does not require a regulatory fix. Others argue that the IPO decline is a consequence of the high costs of disclosure—an issue that could be remedied by policy. The main arguments concerning the IPO decline are summarized below.

Regulatory Explanations

[57] Les Brorsen, "Looking Behind the Declining Number of Public Companies," EY, May 18, 2017, at https://corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies.

[58] Jay R. Ritter, Xiaohui Gao Bakshi, and Zhongyan Zhu, *Where Have All the IPOs Gone?* August 26, 2013, at https://ssrn.com/abstract=1954788 or http://dx.doi.org/10.2139/ssrn.1954788.

[59] Steven Davidoff, "A Dearth of IPOs, but It's Not the Fault of Red Tape," *New York Times*, March 28, 2017, at https://www.nytimes.com/2017/03/28/business/dealbook/fewer-ipos-regulation-stock-market.html.

- **Regulatory Compliance.** Some argue that increased regulation can have unintended consequences for companies trying to access capital. Specifically, critics of securities regulation point to laws and regulations enacted during the past two decades that have significantly affected the amount of public company compliance requirements. These laws and regulations include National Association of Securities Dealers (NASD) order-handling rules (1996);[60] the 1999 passage of the Gramm-Leach-Bliley Act (P.L. 106-102); the Regulation Fair Disclosure (2000);[61] the launch of decimalization (2001);[62] the Sarbanes-Oxley Act (2002; P.L. 112-106); the 2003 Global Settlement ruling restricting conflicts of interest between equity research and investment banking;[63] the Regulation National Market System (2005);[64] and the Dodd-Frank Act (2010; P.L. 111-203), among others. (**Figure 3**).
- **Costs of Going Public.** According to the IPO Task Force,[65] public companies in 2011 faced a one-time initial regulatory compliance cost of around $2.5 million and annual ongoing compliance costs of $1.5 million.[66] These costs may outweigh the benefits and discourage some companies from going public.
- **"Deregulation" of Private Offerings.** Some argue that the increased disclosure obligations for public companies coupled with the "unleashing" of investors in the "disclosure-lite" private markets have contributed to the increased use of private offerings as an alternative to public offerings, resulting in a decline in the number of public companies.[67] According to the *Wall Street Journal* and data provider Dealogic, U.S. companies raised $2.43 trillion privately in 2017, around $0.36 trillion or 17% higher than the $2.06 trillion raised from public markets.[68] The 2017 volumes represent the widest differential between the two methods since private capital reportedly surpassed public capital in 2011 (**Figure 4**).[69]

[60] 17 C.F.R. §240.19b-4.

[61] 17 C.F.R. §§240, 243, and 249.

[62] SEC, Commission Notice: Decimals Implementation Plan for the Equities and Options Markets, July 24, 2000, at https://www.sec.gov/rules/other/decimalp.htm.

[63] FINRA, "2003 Global Settlement," at http://www.finra.org/industry/2003-global-settlement.

[64] 17 C.F.R. §§200, 201, 230, 240, 242, 249, and 270.

[65] The IPO Task Force was formed in response to discussions held during the March 11, 2011, Access to Capital Conference at the U.S. Treasury Department. It is composed entirely of a group of private-sector professionals. PRWEB, "IPO Task Force Issues Recommendations to Improve the Capital Markets for Emerging Growth Companies," October 2011, at http://www.prweb.com/releases/2011/10/prweb8893873.htm.

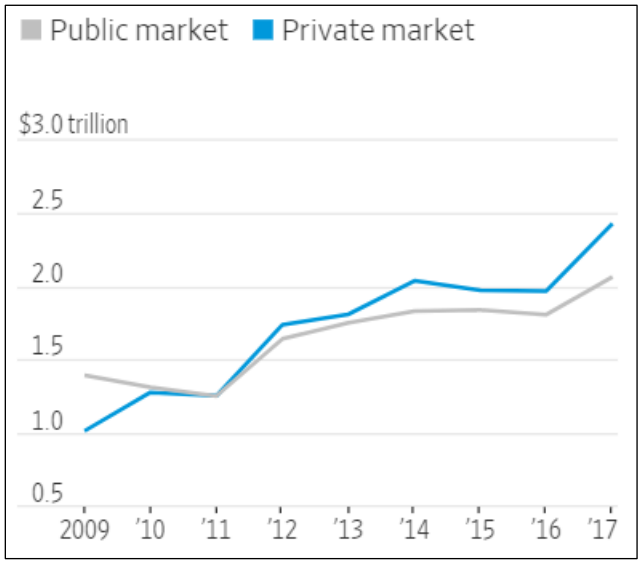
[66] The IPO Task Force, *Rebuilding the IPO On-Ramp Putting Emerging Companies and the Job Market Back on the Road to Growth*, October 2011, at https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

[67] Elizabeth Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, *Duke Law School Public Law & Legal Theory Series* No. 2017-33, April 2017, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2951158.

[68] Jean Eaglesham and Coulter Jones, "The Fuel Powering Corporate America: $2.4 Trillion in Private Fundraising," *Wall Street Journal*, April 2, 2018, at https://www.wsj.com/articles/stock-and-bond-markets-dethroned-private-fundraising-is-now-dominant-1522683249.

[69] Ibid. The *Wall Street Journal* analyzed "tens of thousands of securities filings" and used data from Dealogic to come up with the trend.

Figure 4. Public and Private Capital Raised by U.S. Companies (2009-2017)



Source: Dealogic and *Wall Street Journal* Analysis of SEC Filings, "The Fuel Powering Corporate America: $2.4 Trillion in Private Fundraising," at https://www.wsj.com/articles/stock-and-bond-markets-dethroned-private-fundraising-is-now-dominant-1522683249.

Structural Explanations

- **Economies of "Scope."** Economies of scope may exist when it is more efficient for smaller companies to be acquired than to operate as standalone entities.[70] Some argue that long-term structural changes in product markets have led to declining profitability for smaller companies, whether public or private. In addition, even after going public, smaller companies are said generally to have low liquidity and limited analyst coverage,[71] leaving them unable to reap the full benefits of public listing.[72] These interpretations coincide with increased merger and acquisition activities, which some observers identify as being largely responsible for the delisting of public companies over the last decade.[73]
- **Market Infrastructure.** Some observers argue the market infrastructure needed to support smaller IPOs—such as specialized investment banks and analyst coverage of smaller public companies—is lacking, especially when compared to the market infrastructure for larger IPOs.[74]
- **Agency Conflict.** *Agency conflict* refers to the conflict between owners and managers over the control and use of corporate resources—conflicts that can

[70] Xiaohui Gao, Jay Ritter, and Zhongyan Zhu, *Where Have All the IPOs Gone?* August 2013, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954788.

[71] Analyst coverage matters to stock performance. Cem Demiroglu and Michael Ryngaert, *The First Analyst Coverage of Neglected Stocks*, *Financial Management*, vol. 39, no. 2 (summer 2010), at http://www.jstor.org/stable/40732449.

[72] Xiaohui Gao, Jay Ritter, and Zhongyan Zhu, *Where Have All the IPOs Gone?* August 2013, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954788.

[73] Credit Suisse, *The Incredible Shrinking Universe of Stocks*, March 22, 2017, at https://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf.

[74] SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission*, April 23, 2006, at https://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

potentially undermine corporate financial health and efficiency. In corporate finance, the owners of firms are generally referred to as *stockholders*. Some argue that some organizations may choose to rely more heavily on public and private debt, rather than public equity, thus potentially avoiding certain agency conflict issues because of the absence of public stockholders. As such, capital funding through private offerings could reduce agency conflicts for those companies and generate operational efficiency and productivity.[75]

- **Financial Globalization.** *Financial globalization* refers to the ease by which capital can flow around the world to find its most valued use. Financial globalization has increased significantly as countries have removed barriers to capital flows and new tools have facilitated cross-border investments. Several recent studies show that although the rest of the world has witnessed more IPOs due to greater financial globalization, U.S. IPO activity has not similarly benefited.[76] A related study does not directly attribute U.S. IPO decline to financial globalization; however, it explains U.S. decline in relative terms when compared to the rest of the world. It is also evident that the global capital flow could affect the demand and supply dynamics of the U.S. domestic capital markets, thus impacting IPO-related capital needs.

In response to issues relating to public offerings, the 115th Congress is considering further expansion of EGC benefits as well as other regulatory-relief proposals, including amendments to disclosure requirements and the expansion of certain preemptions to state "blue sky" laws. The following sections analyze several of these proposals.

Expansion of "IPO On-Ramp"—Emerging Growth Company Status

As noted previously, to address the decline in the number of IPOs over the last two decades and to reduce barriers preventing smaller companies from accessing public offerings, the bipartisan JOBS Act of 2012 created a scaled-down alternative to standard IPOs for smaller companies that meet the criteria to be deemed emerging growth company (EGC) issuers. This streamlined process is referred to as an IPO On-Ramp.

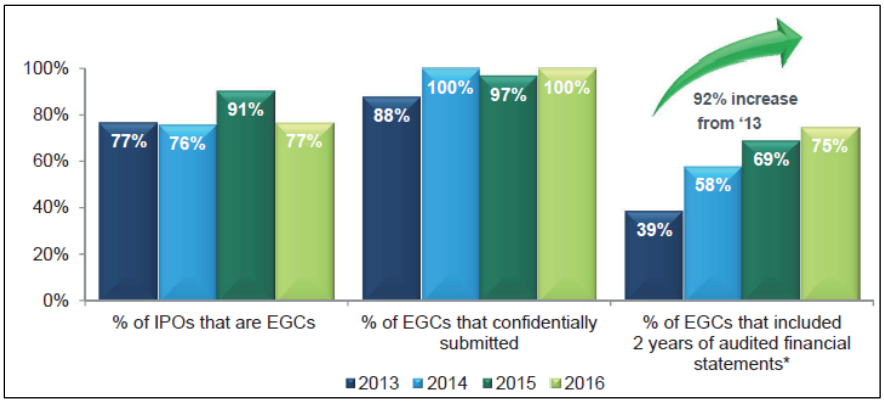
The IPO On-Ramp is a widely used JOBS Act provision. Around 87% of firms filing for an IPO after April 2012 were EGCs, meaning that only 13% of all IPOs since April 2012 were still subject to the conventional IPO process.[77] Key EGC features—for example, the option to obtain confidential SEC review prior to public disclosure and elect for reduced disclosure of audited financials—are features adopted by the majority of IPO firms through the EGC status (**Figure 5**).

[75] This view is from a frequently cited 1989 *Harvard Business Review* article that famously predicted the current market landscape. As of March 2018, the article had been downloaded 15,273 times, with 238 citations, and ranked 162nd out of around half a million articles collected through the Social Science Research Network. Michael Jensen, "Eclipse of the Public Corporation," *Harvard Business Review*, October 1989, revised 1997, at https://papers.ssrn.com/sol3/papers.cfm?abstract-id=146149.

[76] Craig Doidge, G. Andrew Karolyi, and René M.Stulz, *The U.S. Left Behind? Financial Globalization and The Rise of IPOs Outside the U.S.*, December 2013, at https://www.sciencedirect.com/science/article/pii/S0304405X13002092; and Craig Doige, G. Andrew Karolyi, and Rene M. Stulz, *The U.S. Listing Gap*, July 2015, available at https://www8.gsb.columbia.edu/faculty-research/sites/faculty-research/files/finance/Finance%20Seminar/Fall%202015/Doidge_Karolyi_Stulz_Listing_Gap_July2015.pdf.

[77] Department of Treasury, *A Financial System that Creates Economic Opportunities*: *Capital Markets*, October 2017, at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

Figure 5. Post-JOBS Act Emerging Growth Company Trends



Source: Proskauer, *2017 IPO Study*, at http://www.proskauer.com/files/uploads/Proskauer-2017-IPO-Study.pdf.

Notes: Excludes two EGCs in 2015 and three in 2016 that provided financial statements since inception (i.e., the period of time since inception of the company, which may be less than two years). The study includes IPOs listed on a U.S. exchange with minimum initial base deal of $50 million in first public filing.

Following the rapid adoption of EGC status, new proposals in the 115th Congress would further expand the length of time an EGC could maintain its status, and would also expand certain EGC benefits to all IPOs.

Proponents of regulatory relief stated that the EGC regime has enabled deeper capital formation without sacrificing investor protection, arguing that many private companies are still reluctant to go public, and suggesting further action.[78] Some proponents believe the EGC program serves as a model for additional capital-formation-related regulation.[79] As mentioned in the "Raising Capital Through Securities Offerings" section of the report, the test-the-waters and confidential-review features of the EGC framework can be particularly valuable for companies in industries where stock valuation is uncertain and the timing of the IPO depends on regulatory or other approval. For example, biotechnology and pharmaceutical industries reportedly have especially benefited from the EGC status. An executive from one biotechnology company that went public as an EGC testified in support of further expanding the EGC program, noting that 212 emerging biotech companies went public under EGC status as of March 2017, relative to 55 biotech IPOs in the five years leading up to the JOBS Act. The company argued this makes the EGC framework a significant capital access tool for biotechnology innovation.[80]

Critics point to the lighter regulatory standards under EGC, on top of other disclosure-related investor protection risks. They believe EGC is a regulatory label indicating lighter standards for listing. The EGC regime, they argue, appears to have enabled many relatively financially weak companies to conduct IPOs. The opponents believe that EGC companies tend to be lower in quality from a listing and investment perspective. In addition, these companies experienced

[78] Testimony of Edward Knight, Executive Vice President, Nasdaq, Inc., before the U.S. House of Representatives Subcommittee on Capital Markets, Securities, and Investment, March 22, 2017, at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-eknight-20170322.pdf.

[79] Testimony of Thomas Quaadman, Executive Vice President, U.S. Chamber of Commerce, before the U.S. House of Representatives Subcommittee on Capital Markets, Securities, and Investment, March 22, 2017, at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-tquaadman-20170322.pdf.

[80] Testimony of Brian Hahn, CFO of GlycoMimetics, Inc. on behalf of the Biotechnology Innovation Organization, before the U.S. House of Representatives Subcommittee on Capital Markets, Securities, and Investment, March 22, 2017, at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-bhahn-20170322.pdf.

underpricing relative to similarly sized companies prior to the JOBS Act.[81] Underpricing refers to IPOs that are issued at below market value, leaving less money to fund company growth.

Examples of Bills That Would Affect EGCs and IPO On-Ramp

EGC Term Extension—Title V of S. 488, Title IX Subtitle F of H.R. 6147, Section 441 of H.R. 10, Title III of H.R. 3978, S. 2126, and H.R. 1645, Fostering Innovation Act. The bills would extend the exemption until the earlier of 10 years after the EGC went public, the end of the fiscal year in which the EGC's average gross revenues exceed $50 million, or when the EGC qualifies with the SEC as a large accelerated filer ($700 million public float, which is the number of shares that are able to trade freely among investors that are not controlled by corporate officers or promoters).

Expand EGC Benefits to Non-EGCs—Title IX of S. 488, Title IX Subtitle K of H.R. 6147, Section 499 of H.R. 10, S. 2347, and H.R. 3903, Encouraging Public Offerings Act. Under these bills, all issuers making an initial public offering would be allowed to communicate with potential investors before the offering and file confidential draft registration statements with the SEC. These benefits were previously available only to EGC status companies. (The SEC expanded the EGC confidential review benefit to all companies effective on July 10, 2017.)[82]

Title XXXI of S. 488 and H.R. 6324, Middle Market IPO Underwriting Act. The bills would direct the SEC to conduct a study on small- and mid-sized company IPO underwriting costs.

Disclosure Requirements

SEC registration and disclosure are at the core of securities regulation. They are also central components of securities valuation and price discovery. Firms need capital and investors need information to evaluate investment conditions. Issuers have incentives to disclose information if they are to compete successfully for funds against alternative investment opportunities. Consistent with this understanding, early research shows that voluntary disclosure reduces firms' cost of capital. Early evidence also shows that firms voluntarily disclose significant amounts of information beyond what is mandated by securities regulators.[83] Despite the strong support of required and even voluntary disclosure identified in earlier research, current debates about disclosure are more focused on disclosure costs and information overload.

As discussed previously, issuers currently have to provide a significant amount of disclosure of company information throughout the SEC registration process. The SEC requires that offers and sales of securities either be registered with the SEC or be undertaken with an exemption from registration. Different levels of filings and disclosures are required for both public and private offerings. Column three of **Table 1** presents these disclosure requirements. The disclosure-based approach is not without drawbacks. Some question the efficacy of disclosures and suggest they could be so exhaustive as to be counterproductive.[84] Concerns also exist regarding whether both retail and institutional investors could comprehend the disclosed information.

[81] Testimony of Andy Green, Managing Director of Economic Policy, Center for American Progress, before the U.S. House of Representatives Subcommittee on Capital Markets, Securities, and Investment, March 22, 2017, at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-agreen-20170322.pdf.

[82] SEC, "SEC's Division of Corporation Finance Expands Popular JOBS Act Benefit to All Companies," press release, June 29, 2017, at https://www.sec.gov/news/press-release/2017-121.

[83] Robert Romano, *Empowering Investors: A Market Approach to Securities Regulation*, Yale Law School Faculty Scholarship Series, Paper No. 1914, January 1, 1998, at http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2976&context=fss_papers.

[84] Omri Ben-Shahar and Carl E. Schneider, *More Than You Wanted To Know The Future of Mandated Disclosure*, (Princeton, NJ: Princeton University Press, 2016).

Disclosure "Materiality"

Some companies struggle to determine precisely what information must be disclosed as part of the registration process. A general standard governing information to be disclosed under the securities laws is the concept of "materiality." *Materiality* pertains generally to the likely importance of a disclosure to a reasonable investor. SEC Rule 405 states, "When used to qualify a requirement for the furnishing of information as to any subject, [materiality] limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."[85] There is also significant case law concerning the concept of "materiality" in the courts, and it is generally defined in terms of whether a reasonable investor would have viewed the undisclosed information as having "significantly altered the total mix of information available."[86]

Ideally, from an economic perspective, the securities disclosures would neither be so restrictive that they omit essential information, nor so voluminous that they create information overflow or exhaust resources on irrelevant information.

The concept of materiality has always posed challenges for regulators and issuers, as it is often difficult to apply consistent standards for determining materiality at the level of individual companies. Certain discretion has been given to companies through a principle-based approach, which means the companies would have some flexibility to provide disclosures that they believe are material to reasonable investors.[87] A principle-based approach may provide additional flexibility for companies to make decisions about materiality on a case-by-case basis, which is also how the courts generally assess materiality, but the lack of a "bright line" about what exactly must be disclosed can make it difficult for both investors and companies. One recent example is that different companies interpreted the threshold for disclosing material cyber breaches vastly differently.[88] There is generally no bright-line approach on materiality. It is difficult, if not impossible, to provide a clean-cut approach as to materiality for all situations; thus, companies reportedly struggle to know when to disclose and when to hold back.[89]

Disclosure Costs and Readability

Public offerings generally face more rigorous and costly disclosure requirements relative to private offerings. Public company disclosure starts with an initial registration statement that includes a detailed description of the business, the security offered, and the management team, as well as audited financial statements, among other things. The reporting continues with the ongoing disclosure of quarterly and annual financials as well as the disclosure of key operational changes and corporate-governance-related information and events for shareholder voting.[90] Public

[85] 17 C.F.R. §230.405.

[86] See Basic v. Levinson, 485 U.S. 224 (1988).

[87] Keith Higgins, SEC Director, Division of Corporation Finance, "Shaping Company Disclosure: Remarks Before the George A. Leet Business Law Conference," October 2014, at https://www.sec.gov/news/speech/2014-spch100314kfh#_edn3.

[88] Megan Gordon and Daniel Silver, "The Equifax Hack, SEC Data Breach, and Issuer Disclosure Obligations," Harvard Law School, October 2017, at https://corpgov.law.harvard.edu/2017/10/05/the-equifax-hack-sec-data-breach-and-issuer-disclosure-obligations/.

[89] Emily Chasan, "Definition of Materiality Depends Who You Ask," *Wall Street Journal*, November 3, 2015, at https://blogs.wsj.com/cfo/2015/11/03/definition-of-materiality-depends-who-you-ask.

[90] SEC, *Researching Public Companies Through EDGAR: A Guide for Investors*, at https://www.sec.gov/oiea/Article/edgarguide.html.

company regulatory compliance costs were estimated in 2011 to average about $2.5 million, with annual ongoing compliance costs of $1.5 million.[91]

Although disclosure requirements and related costs have increased over time, readability of disclosed information has become a regulatory concern in recent years. One of the most-cited examples is the size of Walmart's IPO prospectus in 1970, which totaled less than 30 pages.[92] This compares to the hundreds of pages commonly expected of today's IPO filings. Studies show that the median text length of certain key SEC filings doubled between 1996 and 2013, yet the readability and the mix of "hard" information, which refers to the informative numbers in the text, have decreased.[93] According to former SEC Chair Mary Jo White, most of this evolution was due to increased SEC rules and guidance that have required increasingly specific and detailed disclosures. This development eventually triggered regulatory discussions regarding "information overload," a term for the high volume of disclosure that can make it difficult for investors to find the most relevant information.[94]

The issue is further complicated when considering the types of investors to which the disclosed information is tailored. The majority of outstanding publicly traded U.S. company stocks are held by institutional investors. Their information needs and preferences may differ from those of retail investors.[95] For example, more sophisticated institutional investors may find detailed reporting useful, whereas retail investors may have a harder time navigating the "information overload" and find "plain English" an easier way to comprehend investment disclosures. Some of these divergent preferences could be too costly to reconcile, because the current disclosure regime does not require different versions of disclosure by investor type.[96] As such, the investor type that should serve as the benchmark for disclosure and reporting requirements continues to be a topic of debate.

Current Congressional and SEC Actions

Several current legislative proposals and agency actions would ease disclosures. Recent agency actions include SEC's rulemaking initiatives on Regulation S-K, which concerns disclosure of information not found on financial statements. As required by Congress through Section 108 of the JOBS Act and Section 72003 of the Fixing America's Surface Transportation (FAST) Act, the SEC completed two studies on disclosure requirements, aiming to "modernize and simplify" disclosures.[97] The SEC subsequently proposed amendments to Regulation S-K on October 11, 2017, incorporating recommendations from the studies.[98]

---

[91] The IPO Task Force, *Rebuilding the IPO On-Ramp Putting Emerging Companies and the Job Market Back on the Road to Growth*, October 2011, at https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

[92] Wal-Mart IPO prospectus, 1970, at http://ruckercapitaladvisors.com/member/wallmart_ipo.

[93] Travis Dyer and Mark Lang, *The Evolution of 10-K Textual Disclosure: Evidence from Latent Dirichlet Allocation*, *Journal of Accounting and Economics*, August 19, 2017, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2741682.

[94] Former SEC Chair Mary Jo White, "The Path Forward on Disclosure," October 15, 2013, at https://www.sec.gov/news/speech/spch101513mjw.

[95] Alicia Davis, "A Requiem for the Retail Investor?" *Virginia Law Review*, vol. 95, no. 4 (2009).

[96] Ibid.

[97] SEC, *Report on Review of Disclosure Requirements in Regulation S-K as Required by Section 108 of the JOBS Act*, December 2013, at https://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf; and SEC, *Report on Modernization and Simplification of Regulation S-K as Required by Section 72003 of the Fixing America's Surface Transportation Act*, November 2016, at https://www.sec.gov/files/sec-fast-act-report-2016.pdf.

[98] SEC, "SEC Proposes Rules to Implement FAST Act Mandate to Modernize and Simplify Disclosure," press release,

Regulation S-K is a key part of the integrated disclosure regime. Issuers of securities offerings, especially public offerings, must file various disclosure documents that include, but are not limited to, Regulation S-K, Regulation S-X (financial statement disclosure requirements), and Regulation S-T (electronic filing regulations).[99] The first version of Regulation S-K included only two disclosure requirements—a description of business and a description of properties. Over time, new disclosure requirements were added to Regulation S-K, and now it is the repository for the nonfinancial statement disclosure requirements under the Securities Act and the Exchange Act.[100]

As one law firm points out, the SEC rulemaking proposal to amend Regulation S-K includes approximately 30 discrete changes. Although none of the changes are likely to have a significant impact individually, taken together they could affect the preparation and presentation of disclosure documents, potentially reducing costs associated with disclosures.[101]

In addition to the agency initiatives, Congress has proposed a number of bills to further amend disclosure requirements (see text box below). Most of these amendments relate to the exemption of issuers from specific registration and reporting requirements. There is also a proposal to expand eligibility for smaller companies to use a more simplified registration form.

Some may argue that these proposals could circumvent the previously discussed tradeoff between capital formation and investor protection by increasing readability and usefulness of disclosures without coming at the expense of the exclusion of material information. Others argue that any decrease in regulation or disclosure would affect the effectiveness of investment decisionmaking and increase the risks facing investors.

Examples of Bills That Would Affect Disclosure Requirements

Section 411 of H.R. 10, Subtitle C–Small Company Disclosure Simplification. The bill would exempt from requirements to use Extensible Business Reporting Language (XBRL) for SEC filings (1) emerging growth companies (i.e., companies with revenues below a specified threshold); and (2) on a temporary basis, certain other smaller companies.

Section 426 of H.R. 10 and H.R. 4529, Accelerating Access to Capital Act. The bills would amend the SEC's Form S-3 registration statement for certain smaller reporting companies that have a class of common equity securities listed and registered on a national securities exchange to qualify for a simplified registration and reporting process.

Section 509 of P.L. 115-174, Section 499A of H.R. 10, and H.R. 4279, Expanding Investment Opportunities Act. The law allows certain types of investment companies (closed-end funds) to qualify for a streamlined securities registration and reporting process.

Section 507 of P.L. 115-174, Section 406 of H.R. 10, and H.R. 1343. The law requires the SEC to increase, from $5 million to $10 million, the 12-month sales threshold beyond which an issuer is required to provide investors with additional disclosures related to compensatory benefit plans.

Section 857 of H.R. 10. The bill would repeal the Dodd-Frank Act requirement that companies calculate and disclose the CEO-to-median-worker pay ratio.

Title XXII of S. 488 and H.R. 5970, Modernizing Disclosure for Investors Act. The bills would require the SEC to conduct a cost-benefit analysis of the Form 10-Q quarterly filings.

October 11, 2017, at https://www.sec.gov/news/press-release/2017-192.

[99] SEC Division of Corporation Finance, *Rules, Regulations and Schedules*, at https://www.sec.gov/divisions/corpfin/ecfrlinks.shtml.

[100] Keith Higgins, SEC Director, Division of Corporation Finance, "Shaping Company Disclosure: Remarks Before the George A. Leet Business Law Conference," October 3, 2014, at https://www.sec.gov/news/speech/2014-spch100314kfh.

[101] Ropes & Gary LLP, "SEC's Proposed Modernization of Regulation S-K," October 2017, at https://corpgov.law.harvard.edu/2017/10/27/secs-proposed-modernization-of-regulation-s-k.

Preemption of State "Blue Sky" Laws

Another source of compliance costs for issuers is the fact that certain securities offerings have to navigate both federal- and state-level regulations. Although the SEC regulates and enforces federal securities laws, each state has its own securities regulator who enforces "blue sky" laws. These laws cover many of the same activities the SEC regulates, such as the sale of securities and those who sell them, but are confined to securities sold or persons who sell them within each state.[102]

The SEC and the states differ in their approach to securities regulation. SEC securities regulation requires disclosure of information about securities and their issuers, whereas the majority of states adopt "merit-based" securities regulation.[103] Merit-based regulation generally refers to the authority to deny registration to an offering on the ground that it is substantively unfair or presents excessive risk to investors.[104] In other words, merit regulation prohibits specific conduct upon review. The issuers would have to convince the states that the offerings are fair to investors.

State securities laws predate the first federal securities statute, the Securities Act of 1933, by a couple of decades. Although some federal statutes preempt state securities laws, state regulators retain the ability to police their own jurisdictions. In addition, there is said to be a separate line of tension between federal securities laws and state corporate law.[105] For example, companies' bylaws of incorporation, which affect their corporate governance practices, are traditionally regulated through state corporate law. Some argue that certain federal provisions relating to executive compensation and shareholder voting, among other provisions, have challenged the decisionmaking authority of state regulation.[106]

Public offerings trading on one of the national exchanges—New York Stock Exchange (NYSE), American Stock Exchange (AMEX),[107] and Nasdaq—received preemption of state registration through the enactment of the National Securities Markets Improvement Act of 1996 (NSMIA; P.L. 104-290). NSMIA was a milestone for "covered securities," which are preempted from blue sky laws' registration and qualification requirements. Under NSMIA, covered securities generally include securities (1) listed, or from a listed issuer, on certain national securities exchanges; (2) issued by a registered investment company; (3) sold only to SEC-defined qualified purchasers; or (4) that meet certain exemptions.[108]

---

[102] SEC, *State Securities Regulators*, at https://www.sec.gov/fast-answers/answersstatesecreghtm.html.

[103] The North American Securities Administrators Association (NASAA) coordinates the review of Regulation A offerings for different states. NASAA identifies 29 merit review jurisdictions out of a total of 49 jurisdictions of application. The rest of the states either adapt to disclosure review or are disclosure based, but reserve the right to make comments consistent with the coordinated review protocol. See Form CR-3(b), at http://www.nasaa.org/wp-content/uploads/2014/05/Coordinated-Review-Application-Sec-3b.pdf.

[104] American Bar Association, "State Merit Regulation of Securities," *The Business Lawyer*, vol. 41, no. 3 (May 1986), pp. 785-852, at https://www.jstor.org/stable/40686730.

[105] Donald Langevoort, *Selling Hope, Selling Risk Corporations, Wall Street, and the Dilemmas of Investor Protection*, Oxford University Press, 2016.

[106] Jill Fisch, *Leave It To Delaware: Why Congress Should Stay Out of Corporate Governance*, *Delaware Journal of Corporate Law*, vol. 37, 2013, at http://www.djcl.org/wp-content/uploads/2014/07/LEAVE-IT-TO-DELAWARE-WHY-CONGRESS-SHOULD-STAY-OUT-OF-CORPORATE-GOVERNANCE.pdf.

[107] AMEX was acquired by NYSE in 2008. SEC filing, "NYSE Euronext to Acquire the American Stock Exchange," January 17, 2008, at https://www.sec.gov/Archives/edgar/data/1368007/000119312508008825/dex991.htm.

[108] See more details on 17 C.F.R. §230 at https://www.sec.gov/rules/final/2017/33-10428.pdf; P.L. 104-290; and Thomson Reuters Practical Law Glossary, *Covered Securities*, at https://content.next.westlaw.com/Document/If661d2bef4ae11e498db8b09b4f043e0/View/FullText.html?contextData=(sc.Default)&transitionType=Default.

Public offerings that do not meet the criteria for covered securities may have to comply with certain state-level regulations. Some argue that state laws adversely affect the deployment of securities offerings that are not part of the covered securities universe. States have regulatory responsibility and expertise over small and local securities. However, an issuer operating in multiple states without preemption of state regulation would have to meet different regulatory requirements in each state, increasing operational complexity and costs. On the other hand, proponents argue state regulations prevent fraud or manipulation of securities offerings locally, and are unlikely to be eliminated because of various political reasons.[109]

The National Securities Exchange Regulatory Parity Act (see text box below) is an example of a current legislative proposal that would affect blue sky laws. Under current law, a security, generally through public offering, must be listed, or authorized for listing, on one of the three specified national securities exchanges as discussed above, in order to be exempt from state registration requirements. The bill instead would require that a security be listed, or authorized for listing on any national securities exchanges that have been approved by the SEC.[110] This amendment would allow public offerings to trade on other exchanges, in addition to the currently specified three, to be potentially exempt from state registration. Although the bill was generally considered a technical fix, opponents believe that it creates confusion and encourages a race to the bottom, as exchanges could potentially lower listing standards to compete for business.[111]

Examples of Bills to Preempt State Regulation

Section 501 of P.L. 115-174, Section 496 of H.R. 10, Title IV of H.R. 3978, and H.R. 4546, National Securities Exchange Regulatory Parity Act. The law exempts from state regulation securities designated as qualified for trading in the national market system.

Facilitating Private Offerings

Private offerings have outpaced public offerings in recent years to become the more frequently used option for raising capital, as measured by aggregate capital raised (**Figure 6**).[112] According to an SEC staff white paper, private debt and equity offerings for 2012 through 2016 combined exceeded public offerings by about 26%.[113]

Going public is arguably less of a necessity for certain private companies to raise capital, at least up to a certain size. Institutional investors, including mutual funds, hedge funds, and sovereign-wealth funds, are contributing to the trend of capital markets' increased reliance on private offerings as one of the key factors. For example, although these investors are not traditionally known for investing in startups, they are now allocating capital toward private offerings of high-

[109] Rutheford Campbell Jr., *The Case for Federal Pre-Emption of State Blue Sky Laws*, Heritage Foundation, 2017, at https://www.heritage.org/sites/default/files/2017-02/06_ProsperityUnleashed_Chapter06.pdf.

[110] See CRS bill summary at https://www.congress.gov/bill/115th-congress/house-bill/10.

[111] Minority views on H.R. 5421 (114th Congress), "The 'National Securities Exchange Parity Act of 2016,'" at https://democrats-financialservices.house.gov/uploadedfiles/mv_hr_5421_signed.pdf.

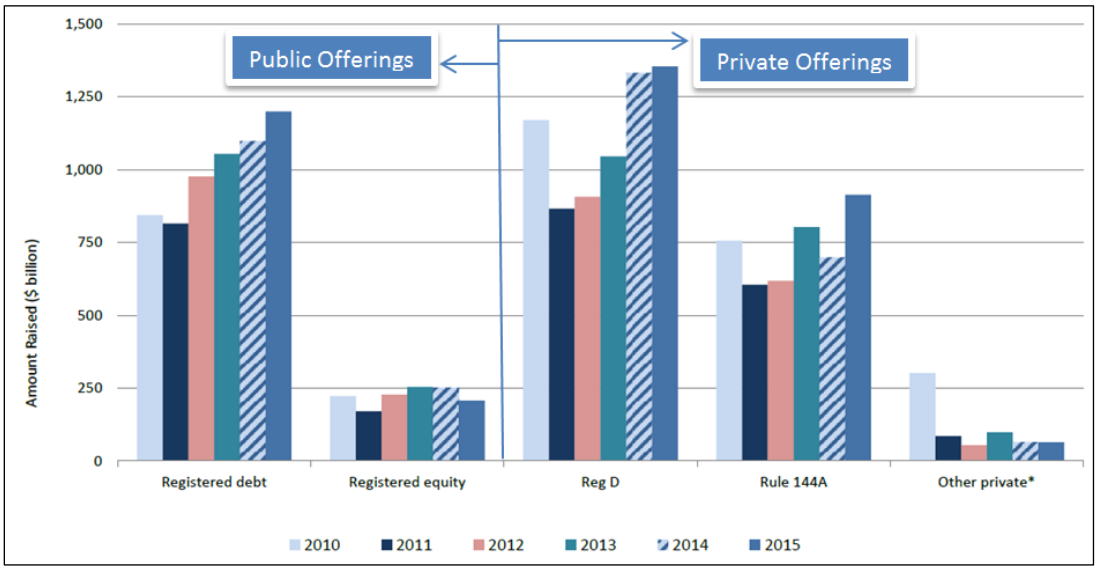
[112] Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014*, Securities and Exchange Commission, at https://www.sec.gov/files/unregistered-offering10-2015.pdf.

[113] SEC, *Access to Capital and Market Liquidity as Directed by the Explanatory Statement to the Consolidated Appropriations Act*, 2016, at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf.

tech "unicorns."[114] The term "unicorn" refers to startup companies that have achieved a valuation of at least $1 billion, while remaining privately funded.

However, concerns persist that smaller companies face difficulties accessing capital. Private offerings are especially important for smaller companies, since they are traditionally viewed as the funding tool for smaller, pre-IPO firms. Some argue that the JOBS Act has not revived public capital access for smaller companies with market capitalization of less than $75 million.[115] The SEC's Advisory Committee on Small and Emerging Companies stated in May 2017 that "identifying potential investors is one of the most difficult challenges for small businesses trying to raise capital."[116]

Figure 6. Aggregate Capital Raised in Securities Markets by Offering Methods



Sources: SEC Division of Economic and Risk Analysis, EDGAR Form D and Form D/A filings for Rule 504, 505, and 506 offerings; Thomson Financial for all others.

Notes: Other private offerings include Regulation S and other Section 4a (2) offerings. The graph does not reflect some of the new private offering programs or new changes to existing programs that became effective after June 2015. Of special note are Regulation Crowdfunding and Regulation A+, which are covered in more detail in the "Policy Issues" section of the report.

Smaller companies' relative difficulty accessing capital through public offerings has encouraged the use of private offerings as an alternative funding source. All else equal, the increased use of private offerings could reduce companies' need to go public. It is within this context that Congress has initiated a number of policy changes and legislative proposals focusing on a scaled regulatory approach that would ease firms' access to private offerings. These proposals fall into three categories: (1) the expansion of investor access to private offerings, (2) the increase in the

[114] Douglas MacMillan and Telis Demos, "Uber Valued at More Than $50 Billion," *Wall Street Journal*, July 31, 2015, at https://www.wsj.com/articles/uber-valued-at-more-than-50-billion-1438367457.

[115] Steven Davidoff, "A Dearth of IPOs, but It's Not the Fault of Red Tape," *New York Times*, March 28, 2017, at https://www.nytimes.com/2017/03/28/business/dealbook/fewer-ipos-regulation-stock-market.html.

[116] SEC Advisory Committee on Small and Emerging Companies, *Recommendation Regarding the Regulation of Finders and Other Intermediaries in Small Business Capital Formation*, May 15, 2017, at https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-051517-finders.pdf.

upper limit and issuer eligibility for Regulation A+, and (3) the creation of a new exemption for micro offerings.

Investor Access to Private Offerings

As shown in **Table 1**, private offerings are often limited in the kinds of investors to which they can be offered. One approach to expanding capital access for private offerings is to expand investor availability. As explained below, policymakers could expand (1) the type of eligible investors by widening the accredited investor definition, (2) the number of eligible investors by increasing the number of nonaccredited investors allowed to participate in private offerings, or (3) the communication to eligible investors by allowing broader outreach. A number of legislative proposals in the 115th Congress (listed in the text box below) would increase investors' access to private offerings along these lines.

As mentioned in the "Capital Formation and Investor Protection" section of the report, investor protection concerns are generally viewed alongside capital formation needs in a policy context. Some have argued that increasing investor access would improve capital formation by creating a larger eligible investor pool for certain securities offerings and would "democratize" investment opportunities by permitting a wider array of investors to participate. However, there are concerns regarding investor protection. Unlike offerings registered with the SEC, certain unregistered offerings lack disclosure of material information, thus exposing investors to higher risk.

Accredited Investors

As mentioned earlier, generally only "accredited" investors are allowed to invest in private offerings. According to federal securities regulations, accredited investors are institutional investors or individual investors who (1) are financially sophisticated, (2) have the wherewithal to sustain financial losses, and (3) have the ability to fend for themselves if faced with adverse circumstances.[117]

The purpose of the accredited investor concept is to identify entities and persons who can bear the economic risk of investing in unregistered securities and to protect ordinary investors from excess risk and potential fraud. According to the SEC, an accredited investor, in the context of an individual, is defined using a number of income and net worth measures: (1) earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and can reasonably be expected to be the same for the current year; or (2) net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence). Around 10% of U.S. households qualified as accredited investors in 2013.[118]

An accredited investor, in the context of an institution, includes certain entities with over $5 million in assets, as well as regulated entities such as banks and registered investment companies that are not subject to the assets test.[119]

Qualifying as an accredited investor is significant because accredited investors may participate in investment opportunities that are generally not available to nonaccredited investors, such as

[117] 17 C.F.R. §230.501.

[118] SEC, *Report on The Review of The Definition of "Accredited Investor,"* December 18, 2015, Table 10.5, at https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf.

[119] SEC, *Report on the Review of the Definition of "Accredited Investors,"* December 18, 2015, at https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf.

investments in private companies and offerings by hedge funds, private equity funds, and venture capital funds.[120]

The income- and net-worth-based definition of an accredited investor has generated criticism, as it arguably suggests that higher net worth equates to investing sophistication. The definition also generates concerns about its sufficiency in capturing those who need investor protection. Some question, for example, whether a widow who relies on her existing net worth for financial security should be eligible for higher-risk investing.

The application of the accredited investor definition faces additional challenges. A definition relying on numeric thresholds provides a clear criterion or guideline for implementation that could produce predictable and consistent results in application. By reading the definition, investors would know if they are accredited investors or not. This approach, however, poses a challenge because certain measures of financial sophistication cannot be easily tracked through standardized numerical approaches or be determined based on income or wealth. This has led some to object to the current accredited investor definition, which is solely based on income and net worth measures.[121]

Threshold Rule

The SEC Threshold Rule (§12(g) of the Securities Exchange Act of 1934) restricts the maximum number of nonaccredited investors allowed to participate in private securities offerings. It establishes the thresholds at which an issuer is required to register a class of securities with the SEC.[122] Prior to the JOBS Act, the Securities Exchange Act of 1934 required a private company to register securities with the SEC if it had total assets exceeding $10 million and shares held by 500 or more shareholders, without regard to nonaccredited investor status.[123] Effective in 2012, the JOBS Act raised the shareholder registration threshold to either 2,000 persons, or 500 persons who are nonaccredited investors.[124] In addition, to address the "Facebook problem"—when companies were forced to go public because the number of shareholders triggered threshold requirements for registration—employee compensation plan holders were no longer considered holders of record.[125]

General Solicitation

Issuers often market their private offerings at promotional events. The events are often sponsored by angel investors (early-stage investors, mostly high-net-worth individuals), venture capital associations, nonprofits, or universities and are used to communicate that a company is interested in, if not actively seeking, investor financing. Certain types of general promotion or advertising were banned for Regulation D private offerings prior to the JOBS Act to prevent nonaccredited

[120] Ibid.

[121] SEC staff paper, *Report on the Review of the Definition of "Accredited Investor,"* December 18, 2015, at https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf.

[122] 15 U.S.C. §78l.

[123] Exchange Act Section 12(g), 15 U.S.C. §78l.

[124] For issuers who are not banks or bank holding companies.

[125] Facebook's and Microsoft's IPOs are two examples widely cited by the media. Microsoft's 1986 IPO was reportedly triggered by the shareholder threshold, despite the fact that the company had no capital needs at the time. Facebook, on the other hand, was said to have established a special purpose vehicle (SPV) to pool investor funds and purchase shares from former employees and early investors. If the individual investors in the SPV were each counted as a holder of record, instead of counting the SPV as a single holder, registration concerns would be triggered.

investors from inadvertently investing. The JOBS Act created a new private offering category under Regulation D, wherein issuers are allowed to engage in general solicitations to accredited investors while taking "reasonable steps" to verify their accredited status.[126]

Some market participants have advocated for a further removal of certain general solicitation restrictions, a move welcomed by trade groups that would benefit from reduced compliance costs and reduced uncertainty. Critics of these efforts, however, raise concerns about investor protection, especially given the potential participation of nonaccredited investors in promotional events intended for accredited investors.[127]

Examples of Bills That Would Expand Investor Access to Private Offerings

Accredited Investor Definition

Title IV of S. 488, Title IX Subtitle E of H.R. 6147, Section 860 of H.R. 10, and H.R. 1585. The bills would amend the Securities Act of 1933 accredited investor definition by including certain nonaccredited investors who could demonstrate their relevant financial education and experience. The bills would include, among other investors, those with

- net worth, or joint net worth with their spouse, exceeding $1 million, excluding their primary residence;
- income over the last two years over $200,000, or joint spousal income over $300,000;
- a state-issued financial services license; and
- qualifying education or experience, determined by the SEC.

Title X of S. 488, Title IX Subtitle N of H.R. 6147, and H.R. 3972. The Family Office Technical Correction Act would specify that family offices and family clients are accredited investors under Regulation D. Family offices are entities established by wealthy families to manage their wealth and provide other services to family members, such as tax and estate planning services.[128]

Threshold Rule

Section 497 of H.R. 10, and H.R. 5051. The provision would expand the number of nonaccredited investors allowed for private offerings under the SEC registration threshold. The provision raises the SEC threshold for companies to register as public reporting companies to 2,000 nonaccredited investors from 500 nonaccredited investors, among other amendments.

General Solicitation

Section 452 of H.R. 10, H.R. 79, and Section 913 of H.R. 3280. The provisions would direct the SEC to revise Regulation D, which exempts certain offerings from SEC registration requirements but prohibits general solicitation or general advertising with respect to such offerings. Under this provision, the prohibition would not apply to events with specified kinds of sponsors, including "angel investor groups" that are unconnected to broker-dealers or investment advisers, if specified requirements are met.

"Mini-IPO"—Regulation A+

Another way that some propose to facilitate capital formation is the further expansion of Regulation A+. Regulation A+, or "Mini-IPO," is a private exemption to facilitate private offering capital access for small- to medium-sized companies. A mini-IPO is like a regular IPO in the sense that it has no resale restrictions and could potentially list on public stock exchanges. But unlike an IPO, it is subject to offering size limits and certain investment limits on nonaccredited investor access, as summarized in **Table 1**. Regulation A+, which expanded the existing Regulation A, became effective on June 19, 2015, a few years after the signing of the JOBS Act

[126] CRS Insight IN10632, *H.R. 79, Section 452 of H.R. 10, and Section 913 of H.R. 3280: Helping Angels Lead Our Startups*, by Gary Shorter; and SEC, "General Solicitation – Rule 506(c)," at https://www.sec.gov/smallbusiness/exemptofferings/rule506c.

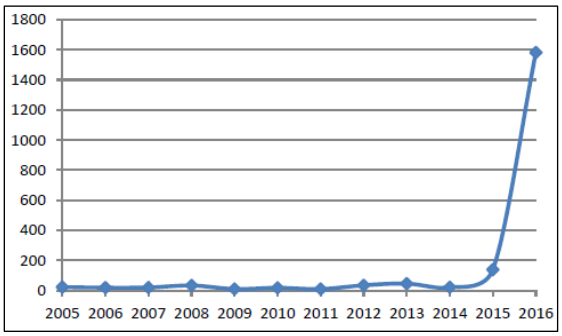
[127] Ibid.

[128] SEC, *Family Office A Small Entity Compliance Guide*, 2011, at https://www.sec.gov/rules/final/2011/ia-3220-secg.htm.

in 2012. Regulation A was a little-used regulatory regime prior to the JOBS Act; starting from the enactment of Regulation A+, the offerings have significantly expanded as measured by the number of total qualified offerings and the aggregate qualified offerings amounts sought (**Figure 7**).

Figure 7. Aggregate Capital Raised in Qualified Regulation A Offerings

2005-2016 (in millions of dollars)



Source: SEC Division of Economic and Risk Analysis. SEC report to Congress, *Access to Capital and Market Liquidity*, August 2017, at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf.

Note: Not inflation-adjusted.

Regulation A+ provides two tiers of offerings:[129]

- Tier 1, which allows securities offerings of up to $20 million in a 12-month period, with not more than $6 million in offers by selling to security-holders that are affiliates of the issuer. Tier 1 is subject to both state and federal registration and qualification requirements.
- Tier 2, which allows securities offerings of up to $50 million in a 12-month period, with not more than $15 million in offers by selling to security-holders that are affiliates of the issuer. Certain qualified purchasers of Tier 2 offerings are exempt from state securities law registration and qualification requirements.

Despite the regime's perceived high potential and upward trend, some contend it has fallen short of expectations for the following reasons:[130]

- **Capital Raised Is Relatively Low.** Regulation A+'s aggregate capital raised in qualified offerings, less than $2 billion as of 2016, seems low compared to the total private market debt and equity issuance of $1.68 trillion in 2016.[131]
- **Public Trading Is Rare.** Although securities issued under Regulation A+ have traded on public exchanges in a few cases, the entering of Regulation A+ into public trading platforms is still uncommon.[132] According to the *Wall Street*

[129] SEC, "Regulation A+ Fact Sheet," March 25, 2015, at https://www.sec.gov/news/pressrelease/2015-49.html.

[130] Bill Alpert, Brett Arends, and Ben Walsh, "Most Mini-IPOs Fail the Market Test," *Barron's*, February 13, 2018, at https://www.barrons.com/articles/most-mini-ipos-fail-the-market-test-1518526753.

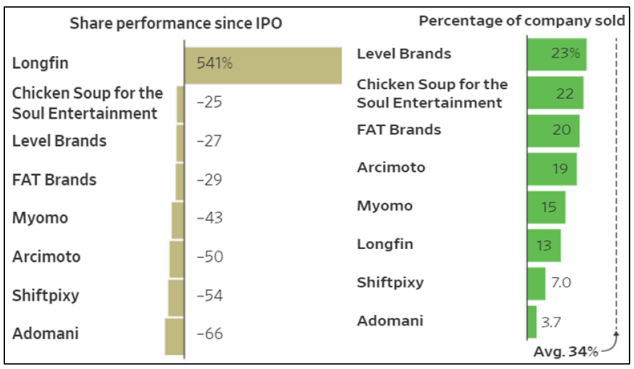
[131] The SEC chart illustrates the aggregate amounts to be $1.6 billion, but the same report also indicated $1.8 billion for 2016. SEC, *Access to Capital and Market Liquidity as Directed by the Explanatory Statement to the Consolidated Appropriations Act, 2016*, at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf.

[132] Rod Turner, "$30M Chicken Soup Regulation A+ IPO Lists On The NASDAQ. Here's How They Made It Happen," *Forbes*, August 18, 2017, at https://www.forbes.com/sites/rodnturner/2017/08/18/30m-chicken-soup-regulation-a-ipo-lists-on-the-nasdaq-oversubscribed-how-they-did/#66160c271366.

Journal, there were eight listed mini-IPOs in 2017. Seven of the eight were trading at an average of 42% below their offer prices (relative to average price rise of 22% for a traditional IPO in 2017). On average, around 15% of mini-IPO companies' total stock was available to trade in 2017, relative to 34% for all U.S.-listed IPOs, making the stocks harder to trade and more volatile (**Figure 8**).[133]

- **Financial Industry Is the Heaviest User So Far.** The program is not broadly adopted; around 37% of Regulation A+ filings and half of proceeds go to finance, insurance, and real estate companies.[134]

Figure 8. Stock Performance of Publicly Listed Regulation A+ Companies



Sources: Corrie Driebusch and Juliet Chung, "IPO Shortcuts Put Burden on Investors to Identify Risk," *Wall Street Journal* and Dealogic, February 6, 2018, at https://www.wsj.com/articles/ipo-shortcuts-put-burden-on-investors-to-identify-risk-1517913000.

There are legislative proposals in the 115th Congress to further expand Regulation A+'s upper limit (H.R. 4263) and to broaden its eligible issuer base (H.R. 2864).

Some have proposed expanding the upper limit of Regulation A+, arguing that in its current form it still faces hurdles in gaining market acceptance because such offerings cost more than a traditional private placement, but tend not to attract major underwriters, broker-dealers, and research coverage, because the deal sizes are small relative to a traditional IPO. Some believe that further lifting the upper limit would potentially alleviate size-related concerns for market intermediaries.[135] Proponents of a proposal to broaden the Regulation A+ eligible issuer base also argue that thousands of SEC reporting companies are currently not able to access Regulation A+. By allowing more companies to use Regulation A+, it would enhance capital formation.[136]

[133] Corrie Driebusch and Juliet Chung, "IPO Shortcuts Put Burden on Investors to Identify Risk," *Wall Street Journal*, February 6, 2018, at https://www.wsj.com/articles/ipo-shortcuts-put-burden-on-investors-to-identify-risk-1517913000.

[134] Anzhela Knyazeva, *Regulation A+: What Do We Know So Far?* SEC, at https://www.sec.gov/files/Knyazeva_RegulationA%20.pdf.

[135] Tom Zanki, "House Panel Approves Bill Lifting Reg A+ IPO Limit To $75M," *Law360*, November 16, 2017, at https://www.law360.com/articles/986052/house-panel-approves-bill-lifting-reg-a-ipo-limit-to-75m; and discussions at Government-Business Forum on Small Business Capital Formation, at https://www.sec.gov/info/smallbus/sbforum.shtml.

[136] OTC Markets Group Inc., "Petition for Rulemaking to Amend Regulation A to make SEC Reporting Companies Eligible Issuers and Permit At the Market Offerings," June 6, 2016, at https://www.sec.gov/rules/petitions/2016/petn4-699.pdf.

Others consider the expansion of Regulation A+ to potentially reduce incentives for companies to go public, thus undermining public securities markets.[137] This could be to the detriment of both investors and markets, as public offerings provide greater investor protection and liquidity for trading.[138] Some observers argue against immediate expansion, raising concerns that the regime is still in its early stages, and that demand and participation have not yet stabilized. In 2015, the upper limit for Regulation A+ was increased 10 times, to $50 million from $5 million. The program's long-term effects have not been observed in full,[139] leading some to question whether now is the optimal time to extend the program, especially given that the SEC already has the discretion to change the size limit under the current rule.[140]

Example of Bills That Would Expand Mini-IPOs

Section 498 of H.R. 10, and H.R. 4263, Regulation A+ Improvement Act of 2017. The provision would increase the upper limit of offerings that are exempt from registration, subject to eligibility, disclosure, and other matters as specified in Regulation A+.

Section 508 of P.L. 115-174, and H.R. 2864, Improving Access to Capital Act. The provision directs the SEC to expand Regulation A+ rules to include "fully reporting" companies.[141] Regulation A+ currently applies to nonreporting companies only.

Micro Offering

There is considerable demand for seed and startup capital for U.S. small businesses, some of which may be at the forefront of technological innovation and job creation. Yet some companies may be too small to realistically issue private offerings under existing exemptions. For example, an official from the U.S. Small Business Administration stated that 25% of startups report having no startup capital, while 20% cite lack of access to capital as a primary constraint to their business health and growth.[142] Proposals related to what are referred to as *micro offerings* are intended to assist small businesses that are deemed to have insufficient capital access. Specifically, the Micro Offering Safe Harbor Act[143] proposes a new private offering that would exempt certain micro funding from federal registration as well as state blue sky laws. The exempted micro offerings would also be required to meet each of the following requirements:[144]

- Each investor has a substantive preexisting relationship with an owner.
- There are 35 or fewer purchasers.

[137] Americans for Financial Reform letter to Congress on November 13, 2017, at http://ourfinancialsecurity.org/wp-content/uploads/2017/11/AFR-Letter-Re-HFSC-11-14-Markup.pdf.

[138] Ibid.

[139] SEC, *Access to Capital and Market Liquidity as Directed by the Explanatory Statement to the Consolidated Appropriations Act*, August 2016, at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf.

[140] Sections 3(b)(2)-(5) of P.L. 112-106 specifies mandatory terms and conditions for such exempt offerings and also authorize the commission to adopt other terms, conditions, or requirements as necessary in the public interest and for the protection of investors. 17 C.F.R. §§200, 230, 232, 239, 240, 249, and 260.

[141] A fully reporting company is a company that is filing registration and reporting with the SEC, either voluntarily or through public offering requirements.

[142] Michelle Schimpp, U.S. Small Business Administration, speech at SEC-NYU Dialogue on Securities Crowdfunding, February 28, 2017, at https://www.sec.gov/files/Highlights%20from%20the%20SEC-NYU%20Dialogue%20on%20Securities-Based%20Crowdfunding.pdf.

[143] H.R. 2201.

[144] See CRS bill summary at https://www.congress.gov/bill/115th-congress/house-bill/2201.

- The amount does not exceed $500,000.

Proponents believe it would more easily allow small businesses and startups to raise limited amounts of capital from their personal network of family and friends without running afoul of federal and state securities laws.[145] Business trade groups have stated that the micro offering legislation would "appropriately scale" federal rules and regulatory compliance for small businesses.[146]

Opponents, however, raise investor protection concerns stemming from reduced disclosures and the absence of provisions to disqualify "bad actors" with criminal records, among other things. One point of contention is that micro offerings would not be subject to resale restrictions, meaning they could be immediately sold off to other qualified investors. The lack of a resale restriction for unregistered securities could expose investors to potential "pump and dump" schemes,[147] a form of securities fraud that involves artificially boosting the price of a security in order to sell it for more.[148]

The Congressional Budget Office (CBO) has estimated that only a relatively small number of securities transactions would be covered under the expanded exemption that are not currently covered by other existing exemptions.[149]

Examples of Bills That Would Expand Micro Offerings

Section 461 of H.R. 10, and H.R. 2201, Micro Offering Safe Harbor Act. The provisions would exempt certain micro offerings from (1) state regulation of securities offerings, and (2) federal prohibitions related to interstate solicitation. This exemption would allow for the participation of small offerings without triggering the Securities Act registration and state blue sky securities laws.

Facilitating Fintech Offerings

The development of financial technology ("fintech")[150] has disrupted industries and led to new capital access options not previously overseen by the SEC regulatory regime. Policymakers are now considering whether these new innovations fit well within the existing regulatory framework, or whether the framework should be adapted to address the risks and benefits that they pose. This development affects not only the SEC, but also other financial regulators within the United States and across various global jurisdictions.

[145] House Majority Leader Kevin McCarthy, "The House Helps Small Businesses Get Off the Ground," press release, November 9, 2017, at https://www.majorityleader.gov/2017/11/09/micro-offerings.

[146] Several small business advocacy organizations have endorsed the Micro Offering Safe Harbor Act, including the National Small Business Association and the Small Business & Entrepreneurship Council (SBEC). The SBEC stated, "The legislation would appropriately scale federal rules and regulatory compliance for small businesses, thus providing another practical option for entrepreneurs to raise the capital they need to startup or grow their firms." Rep. Tom Emmer, "Emmer Introduces Micro Offering Safe Harbor Act," press release, March 23, 2016, at https://emmer.house.gov/media-center/press-releases/emmer-introduces-micro-offering-safe-harbor-act.

[147] H.Rept. 115-383.

[148] SEC, "Pump and Dump Schemes," at https://www.investor.gov/protect-your-investments/fraud/types-fraud/pump-dump-schemes.

[149] CBO, "Cost Estimate of H.R. 2201, Micro Offering Safe Harbor Act," October 30, 2017, at https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/hr2201.pdf.

[150] For more on fintech, see CRS In Focus IF10513, *Introduction to Financial Services: "Fintech"*, by David W. Perkins.

Crowdfunding and initial coin offerings (ICOs) are two of the most popular fintech capital access tools that are regulated by the SEC, if they fall within the definition of being securities.[151]

Securities-Based Crowdfunding

Crowdfunding generally refers to a financing method in which money is raised through soliciting relatively small individual investments or contributions from a large number of people.[152] Four kinds of crowdfunding exist: (1) donation crowdfunding, where contributors give money to a campaign and receive in return, at most, an acknowledgment; (2) reward crowdfunding, where contributors give to a campaign and receive in return a product or a service; (3) peer-to-peer lending crowdfunding, where investors offer a loan to a campaign and receive in return their capital plus interest; and (4) equity crowdfunding, where investors buy stakes in a company and receive in return company stocks.[153] Generally, equity crowdfunding and certain peer-to-peer lending crowdfunding could be subject to SEC regulation if they conform to the definition of securities.

Title III of the JOBS Act created a new exemption from registration for internet-based securities offerings of up to $1 million (inflation-adjusted) over a 12-month period. Title III intends to help small and startup businesses conduct low-dollar capital fundraising from a broad and mostly retail investor base over the internet. The JOBS Act includes a number of investor protection provisions, including investment limitations, issuer disclosure requirements, and a requirement to use regulated intermediaries. The crowdfunding final rule became effective on May 16, 2016.[154]

New Capital Access Venue and the "Wisdom of the Crowd"

Crowdfunding allows investors and entrepreneurs to connect directly, potentially creating access to new investment opportunities and allowing investors to tap into the collective opinions of a large group, often referred to as "the wisdom of the crowd."[155] These new opportunities could provide much-needed seed capital to entrepreneurs who would otherwise lack capital access. To illustrate this point, one SEC staff white paper indicates that the issuers of securities-based crowdfunding tend to be small, young, prerevenue, and not profitable.[156] The effects of crowdfunding facilitating business growth are illustrated by a study that indicated around 70% of reward-based crowdfunding projects resulted in the creation of startups.[157]

---

[151] More details on the definition of a security, see chapter 2 of Robert Rosenblum, *Investment Company Determination Under the 1940 Act: Exemptions and Exceptions*, American Bar Association, 2003 (see also footnote 2).

[152] SEC, *Updated Investor Bulletin: Crowdfunding for Investors*, at https://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html.

[153] Garry Gabison, *Understanding Crowdfunding and its Regulations*, European Commission, 2015, at http://publications.jrc.ec.europa.eu/repository/bitstream/JRC92482/lbna26992enn.pdf.

[154] Vladimir Ivanov and Anzhela Knyazeva, *U.S. Securities-Based Crowdfunding Under Title III of the JOBS Act*, SEC, February 28, 2017, at https://www.sec.gov/dera/staff-papers/white-papers/RegCF_WhitePaper.pdf.

[155] Garry Bruton, Susanna Khavul, Donald Siegel, and Mike Wright, "New Financial Alternatives in Seeding Entrepreneurship: Microfinance, Crowdfunding, and Peer-to-Peer Innovations," *Entrepreneurship Theory and Practice*, vol. 39, no. 1 (2014), pp. 9-26, at http://onlinelibrary.wiley.com/doi/10.1111/etap.12143/abstract.

[156] Vladimir Ivanov and Anzhela Knyazeva, *U.S. Securities-Based Crowdfunding Under Title III of the JOBS Act*, February 28, 2017, at https://www.sec.gov/dera/staff-papers/white-papers/RegCF_WhitePaper.pdf.

[157] Research using Kickerstarter data, which is reward-based crowdfunding, instead of securities-based crowdfunding. Video and highlights from SEC-NYU Dialogue on Securities Crowdfunding, February 2017, at https://www.sec.gov/files/Highlights%20from%20the%20SEC-NYU%20Dialogue%20on%20Securities-Based%20Crowdfunding.pdf.

The total amount of reported securities-based crowdfunding is small relative to the estimated global crowdfunding volume. During the first approximately seven months that the rule was in effect (May 16, 2016, to December 31, 2016), there were 163 unique securities-based crowdfunding offerings by 156 issuers, seeking a total of $18 million (based on the target amount). The median (average) offering targeted approximately $53,000 ($110,000). During a similar time period, a smaller amount was actually raised, with approximately $10 million in proceeds reportedly raised for 33 offerings.[158] These amounts may appear low, but could be partially due to underreporting. The SEC tracks crowdfunding volume using data taken from issuers filing Regulation Crowdfunding Forms C-U, but not all securities issuers initiated the filings.

Securities-based crowdfunding is a relatively small part of the crowdfunding total. As a point of comparison, the estimated global crowdfunding volume for all types of crowdfunding was $139 billion in 2015.[159] A large portion of current online peer-to-peer funding activities are generally not considered "securities-based" crowdfunding subject to SEC regulation. Non-securities-based crowdfunding campaigns do not necessarily involve a profit-seeking business, and ones that do may have a project-specific nature, thus not conforming to the SEC's definition of securities.[160] Peer-to-peer lending, if not considered a security, may still be under the oversight of banking regulators for consumer banking and related regulations.[161]

Potential Benefits and Drawbacks

Crowdfunding's expansion of capital access and "wisdom of the crowd" characteristics are widely cited as benefits of the funding method. Some academic research of selected types of crowdfunding finds that crowdfunding democratizes access to funding, allows the crowd to look for signals of quality, and is "remarkably free" from fraud, even though over 75% of projects ultimately deliver but typically past the date on which it was expected.[162] Others argue that crowdfunding, perhaps more than any other funding method, shows real-world demand for a company's product or service. Crowdfunding signals may reduce the need for disclosures, some have argued, because a successful crowdfunding campaign itself could be a positive signal of company quality, thus making the process more affordable to entrepreneurs.[163] On the other hand, the disclosure process clarifies and codifies terms and conditions of an offering. Regulation Crowdfunding (see **Table 1**), for example, lists the financial statements and other information required for SEC filings.

---

[158] Vladimir Ivanov and Anzhela Knyazeva, *U.S. Securities-Based Crowdfunding Under Title III of the JOBS Act*, February 28, 2017, at https://www.sec.gov/dera/staff-papers/white-papers/RegCF_WhitePaper.pdf.

[159] P. Raghavendra Rau, *Law, Trust, and the Development of Crowdfunding*, University of Cambridge, June 2017, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2989056.

[160] Vladimir Ivanov and Anzhela Knyazeva, *U.S. Securities-Based Crowdfunding Under Title III of the JOBS Act*, February 28, 2017, at https://www.sec.gov/dera/staff-papers/white-papers/RegCF_WhitePaper.pdf. For more details on the definition of a security, see chapter 2 of Robert Rosenblum, *Investment Company Determination Under the 1940 Act: Exemptions and Exceptions*, American Bar Association, 2003.

[161] For a summary of consumer credit regulation, see Morrison Foerster, *Practice Pointers on P2P Lending Basics: How It Works, Current Regulations and Considerations*, at https://media2.mofo.com/documents/150129p2plendingbasics.pdf.

[162] Wharton School of Business, "Crowdfunding Research," at https://crowdfunding.wharton.upenn.edu/research.

[163] Darian Ibrahim, *Crowdfunding Signals*, William & Mary Law School, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3068323.

Regarding equity crowdfunding's balance between capital access and investor protection,[164] some caution that investor protection that is too strong "may harm small firms and entrepreneurial initiatives."[165] Yet others fear investor protection is too weak, given low levels of compliance among many early companies that raised money through crowdfunding and offered "bad terms" to investors.[166]

There are also a number of perceived regulatory concerns, including the following:

- **High Risk and Low Liquidity.** Crowdfunding's securities-based offerings generally have high risk, given the types of prerevenue businesses seeking capital,[167] the possibility of fraud,[168] and the need for disclosure[169] and transparency.[170] Other concerns include the lack of liquidity through secondary markets, the professional guidance and corporate governance structure, investor protection, and platform operations and due diligence.[171]
- **Simple Agreement for Future Equity (SAFE) Securities.** SAFE was developed in 2013 by Y Combinator, a technology accelerator, for investing in startups that expect to raise institutional capital at a later date.[172] SAFE investors receive deferred equity entitling them to future shares. SAFE is the second-most-popular securities-based crowdfunding offering type, representing 26% of total offerings (equity is the most popular, accounting for 36% of offerings).[173] Startups welcome SAFE because of its simplicity and generous terms, including, for example, the capability to potentially cap the upside payout in the event that SAFE investors receive shares. But researchers and regulators are concerned about SAFE's risk to retail investors.[174] These concerns are typically associated

[164] See item one of the "Policy Issues" section of the report for more details on capital formation versus investor protection.

[165] Lars Hornuf and Armin Schwienbacher, *Should Securities Regulation Promote Equity Crowdfunding?*, August 15, 2016, at https://ssrn.com/abstract=2412124.

[166] Nathaniel Popper, "Doubts Arise as Investors Flock to Crowdfunded Start-Ups," *New York Times*, January 24, 2017, at https://www.nytimes.com/2017/01/24/business/dealbook/crowdfunding-fraud-investing-startups.html.

[167] As discussed earlier, the issuers are mostly prerevenue establishments that may have a high possibility of failure.

[168] Thomas Hazen, "Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure," *North Carolina Law Review*, vol. 90, no. 5 (2012), at http://scholarship.law.unc.edu/cgi/viewcontent.cgi?article=4584&context=nclr.

[169] Regulation crowdfunding has a scaled disclosure approach, with higher offering amounts having to disclose more information. The disclosure requirements are generally minimized (although necessary to submit when available, audited financial statements are not required) for offerings of $107,000 or less. For more details, see https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm#3.

[170] Referring to transparency by both issuer and platforms.

[171] CFA Institute, *Issue Brief: Investment-Geared Crowdfunding Sourcing Equity and Debt Funding from the Crowd: Developing a Regulatory Framework*, March 2014, at https://www.cfainstitute.org/ethics/Documents/issue-brief-crowdfunding.pdf; Marc Sharma, Chief Counsel of the SEC's Office of the Investor Advocate, speech at SEC-NYU Dialogue on Securities Crowdfunding, February 28, 2017, at https://www.sec.gov/dera/announcement/dera_event-022817_securities-crowdfunding-in-the-us.html.

[172] Y Combinator, "Announcing the Safe, a Replacement for Convertible Notes," December 6, 2013, at https://blog.ycombinator.com/announcing-the-safe-a-replacement-for-convertible-notes/.

[173] Vladimir Ivanov and Anzhela Knyazeva, *U.S. Securities-Based Crowdfunding Under Title III of the JOBS Act*, SEC, February 28, 2017, at https://www.sec.gov/dera/staff-papers/white-papers/RegCF_WhitePaper.pdf.

[174] Two SEC commissioners and the SEC Office of Investor Advocacy raised concerns about SAFE. Joe Green, "Commentary: SEC Rightly Concerned About 'So-Called SAFE' Securities in Crowdfunding," Reuters, June 1, 2017, at https://www.reuters.com/article/bc-finreg-crowdfunding-safe/commentary-sec-rightly-concerned-about-so-called-

with investor protection regarding how informed investors are of the risks and whether they are compensated accordingly. The SEC issued an investor bulletin in May 2017 to explain SAFE to retail investors.[175]

Some observers argue that SAFE is valuable to the holder only if the company that issues it raises a subsequent round of financing or is sold. However, the vast majority of companies raising capital through SAFE are said to be unlikely to ever raise institutional venture capital.[176]

- **Funding Portals.** The JOBS Act established an exemption to permit securities-based crowdfunding as well as a new type of entity—funding portals. The act allows these internet-based platforms or intermediaries to facilitate the offer and sale of securities without having to register with the SEC as brokers.[177] As of February 20, 2018, there were 38 funding portals that were registered with the SEC and that were members of the Financial Industry Regulatory Authority (FINRA).[178] Funding portals also draw investor protection concerns. An SEC official noted that from May 2016 to January 2017, 27 crowdfunded offerings were withdrawn, and of these, 16 were hosted by a funding portal that was recently expelled by FINRA. This may challenge the conception of funding portals as reliable gatekeepers for these transactions.[179]

A number of legislative proposals would lessen crowdfunding restrictions for both issuers and funding portals. Proponents of the bills state the intention of the bills is to further improve small businesses' access to capital and to provide more investment opportunities for investors of all kinds. Opponents assert that the proposals would "deregulate" crowdfunding offerings that are funding riskier startups, and in so doing would increase investor access while reducing investor protections, such as public disclosures.[180] State securities regulators have asserted that it is too early to determine what changes are needed to improve the crowdfunding law.[181]

safe-securities-in-crowdfunding-idUSKBN18S63M.

[175] SEC Investor Bulletin, *Be Cautious of SAFEs in Crowdfunding*, May 9, 2017, at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes.

[176] Joseph Green and John Coyle, *Crowdfunding and the Not-So-Safe SAFE*, December 10, 2016, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2830213; and Marc Sharma, Chief Counsel of the SEC's Office of the Investor Advocate, speech at SEC-NYU Dialogue on Securities Crowdfunding, February 28, 2017, at https://www.sec.gov/dera/announcement/dera_event-022817_securities-crowdfunding-in-the-us.html.

[177] SEC, *Regulation Crowdfunding Fact Sheet*, at https://www.sec.gov/news/pressrelease/2015-249.html.

[178] FINRA, "Funding Portals We Regulate," February 20, 2018, at https://www.finra.org/about/funding-portals-we-regulate.

[179] SEC Commissioner Kara Stein, "SEC-NYU Dialogue on Securities Market Regulation: U.S. Securities-Based Crowdfunding – Closing Remarks," February 28, 2017, at https://www.sec.gov/news/statement/stein-closing-remarks-sec-nyu-dialogue.html.

[180] Americans for Financial Reform, June 7, 2017, letter to Members of Congress, at http://ourfinancialsecurity.org/wp-content/uploads/2017/06/AFR-Floor-Vote-Letter-CHOICE-Act-07-07-17.pdf.

[181] North American Securities Administrators Association, *A Legislative Proposal to Create Hope and Opportunity for Investors, Consumers, and Entrepreneurs*, April 26, 2017, at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2017/04/NASAA-Statement-for-4-26-17-HFSC-Hearing.pdf.

Provisions That Would Affect Crowdfunding

Section 476 of H.R. 10, Crowdfunding Exemption: Exempt from the Securities Act of 1933 registration requirements of certain small transaction securities offerings.

Section 477 of H.R. 10, Exclusion of Crowdfunding Investors from Shareholder Cap: Amend the Securities Exchange Act of 1934 to exclude securities purchased under Section 476 from the cap on shareholders.

Section 478 of H.R. 10, Preemption of State Law: Clarify certain Subtitle P state preemptions on state registration, documentation, and offering requirements, among other amendments.

Section 479 of H.R. 10, Treatment of Funding Portals: Exclude funding portals from certain reporting requirements.

Title XXXII of S. 488 and H.R. 6380 Crowdfunding Amendments Act: Allow crowdfunding investors to pool investments into funds that are advised by registered investment advisors.

Initial Coin Offerings

A relatively new approach to raising capital is the initial coin offering (ICO). ICOs as a fundraising tool have gained popularity in recent months. ICOs are crowdfunding processes conducted on distributed ledger or blockchain technology.[182] Similar to crowdfunding, ICOs allow for solicitation of relatively small individual investments or purchases from a large number of participants. But instead of traditional crowdfunding's return of investments in the form of products, acknowledgments, interest payments, or a piece of ownership of the firm, ICOs offer supporters digital coins. These coins or tokens are new digital currencies each company creates and sells to the public. Coin purchasers could redeem the coins for goods or services, or hold them as investments in the hope that if the company is successful, the coins would increase in value. ICO investors generally exchange cryptocurrencies (e.g., Bitcoin, Ethereum) or fiat currencies (e.g., U.S. dollars) for the tokens issued pursuant to ICOs.[183]

Although every crypto enterprise is different, they generally provide publicly verifiable transactions, lower transaction costs, and the ability to make transfers without an intermediary or any geographic limitation.[184]

Regulatory Treatment

Some ICOs are securities and are subject to securities regulation. ICOs are generally considered securities if they promise a return based on the management practices of those offering them.[185] For example, the cryptocurrency Bitcoin is not an ICO because it is not issued by a profit-seeking business.[186]

---

[182] See the section above for more details on crowdfunding.

[183] SEC, "Investor Bulletin: Initial Coin Offerings," July 25, 2017, at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

[184] SEC Chairman Jay Clayton, "Statement on Cryptocurrencies and Initial Coin Offerings," December 11, 2017, at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[185] Quotes from SEC Senior Associate Chief Accountant Kevin Vaughn, "SEC Checking If Some Digital Coin Offerings Proffer Securities," *Bloomberg Government*, December 2017.

[186] A more detailed definition of securities could be found through the Howey test. In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court set forth the foundational test for whether a transaction qualifies as a form of security known as an "investment contract." Under *Howey*, an investment contract is (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others. See also *SEC v. Edwards*, 540 U.S. 389, 393 (2004). Rahul Mukhi and James Michael Blakemore, Cleary, Gottlieb, Steen & Hamilton LLP, "SEC Cyber Unit and Allegedly Fraudulent ICO," December 26, 2017, at

In the United States, if an ICO qualifies as a security, its promoters would have to either register with the SEC (as a public offering) or obtain an exemption from registration (as a private offering), similar to the treatment of all other securities. But in practice, many ICOs have not conformed with the restrictions traditionally imposed on private offerings (see **Table 1**); instead, their characteristics include an unlimited offering amount, wide access by both accredited and nonaccredited investors, ability to trade in secondary markets, and limited investor disclosure.[187] Based on these characteristics, an ICO could theoretically comply with securities laws by registering as the type of security shown in **Table 1** that best fits its characteristics, and complying with the requirements of that type. For example, because ICOs are generally considered a combination of crowdfunding (see the section above) and blockchain, they could potentially seek a private offering exemption through Regulation Crowdfunding.[188]

However, as of March 6, 2018, only one ICO has filed for registration with the SEC, even though ICOs have largely been considered offers and sales of securities.[189] This has led the SEC to acknowledge that many promoters of ICOs are not following securities laws.[190] To address this issue, the SEC has increased ICO enforcement efforts,[191] including establishing a new cyber unit.[192] It has also issued investor bulletins and alerts to warn retail investors to proceed with caution. State securities regulators have also issued warnings about ICOs.[193]

The SEC recently halted a number of ICOs and issued dozens of subpoenas and information requests to parties engaged in ICOs. Some of the SEC's enforcement efforts have reportedly focused on ICOs that involve simple agreements for future tokens (SAFTs).[194] Similar to

https://corpgov.law.harvard.edu/2017/12/26/sec-cyber-unit-and-allegedly-fraudulent-ico.

[187] Paul Vigna, "What's an Initial Coin Offering? ICOs Explained in 11 Questions," *Wall Street Journal*, October 2, 2017, at https://www.wsj.com/articles/whats-an-initial-coin-offering-icos-explained-in-11-questions-1506936601?mg=prod/accounts-wsj.

[188] One specific case would be the DAO token, a digital asset offered by a "virtual" organization. The DAO token has been described as a "crowdfunding contract" but it was said to not have met the requirements of the Regulation Crowdfunding exemption because, among other things, it was not a broker-dealer or a funding portal registered with SEC and FINRA. Should such conditions be met, the token could potentially seek crowdfunding private exemption, or otherwise go through full registration for public offering or obtain other eligible private exemptions. SEC, "SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities," press release, July 25, 2017, at https://www.sec.gov/news/press-release/2017-131.

[189] SEC Chairman Jay Clayton, "Testimony on Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission," February 6, 2018, at https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission; and The Praetorian Group SEC filing, *Form S-1*, March 6, 2018, at https://www.sec.gov/Archives/edgar/data/1721980/000137647418000045/pr_s1.htm.

[190] SEC, "Statement of Chairman Jay Clayton and Commissioners Kara M. Stein and Michael S. Piwowar on 'NASAA Reminds Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution' by NASAA," January 4, 2018, at https://www.sec.gov/news/public-statement/statement-clayton-stein-piwowar-010418.

[191] SEC Division of Enforcement, "Statement on Potentially Unlawful Promotion of Initial Coin Offerings and Other Investments by Celebrities and Others," November 1, 2017, at https://www.sec.gov/news/public-statement/statement-potentially-unlawful-promotion-icos.

[192] SEC, "SEC Announces Enforcement Initiatives to Combat Cyber-Based Threats and Protect Retail Investors," press release, September 25, 2017, at https://www.sec.gov/news/press-release/2017-176.

[193] NASAA, "NASAA Reminds Investors to Approach Cryptocurrencies, Initial Coin Offerings and Other Cryptocurrency-Related Investment Products with Caution," January 4, 2018, at http://www.nasaa.org/44073/nasaa-reminds-investors-approach-cryptocurrencies-initial-coin-offerings-cryptocurrency-related-investment-products-caution.

[194] Jean Eaglesham, "Cryptocurrency Firms Targeted in SEC Probe," *Wall Street Journal*, February 28, 2018, at

SAFEs,[195] SAFTs offer investors the right to receive tokens at a future date. Investors receive the actual token only in the event the future network they are funding becomes genuinely functional in producing tokens.[196] The SEC reportedly has concerns that some ICOs, both those with and without SAFTs, could be funding businesses that are nonexistent.[197]

In addition, the SEC intervened to keep public companies from changing their names or business models to capitalize on the hype surrounding ICOs and blockchain technology.[198] These SEC interventions are in reaction to the market response associated with simple name changes that are not backed by substantive track records, which have raised investor protection concerns. Two of the most cited examples are Long Island Iced Tea and Eastman Kodak. Eastman Kodak's stock price more than doubled after it announced the launching of a digital currency, "KodakCoin," for an ICO.[199] Similarly, the stock price of Long Island Iced Tea spiked five-fold after it announced its name change to Long Blockchain (**Figure 9**). These incidents reportedly led to SEC's intervention in certain name changes, resulting in some companies erasing the word "blockchain" from their names.[200] As to Long Blockchain, it received a notice from Nasdaq Stock Market indicating the exchange's intention to delist the company based on its misleading public statements relating to bitcoin and blockchain technology.[201]

https://www.wsj.com/articles/sec-launches-cryptocurrency-probe-1519856266.

[195] See detailed discussion in the "Securities-Based Crowdfunding" section of this report.

[196] According to the SAFT project white paper, token network developers propose to use the SAFT funding from investors to develop future token networks, and promise to deliver the resulting tokens to the investors when the network becomes "genuinely functional." While the SAFT is a security, issuers of SAFT hope that the resulting future tokens could be treated as consumptive "utility" tokens, which are not subject to federal securities regulation. The detailed discussions of utility and securities tokens are outside of the scope of this report. For more details, see Juan Batiz-Benet, Marco Santori, and Jesse Clayburgh, *The SAFT Project: Toward a Compliant Sale Framework*, October 2, 2017, at http://www.saftproject.com/static/SAFT-Project-Whitepaper.pdf.

[197] Matt Robinson, "SEC Is Said to Issue Subpoenas in Hunt for Fraudulent ICOs," Bloomberg, March 1, 2018, at https://www.bloomberg.com/news/articles/2018-03-01/sec-is-said-to-issue-subpoenas-in-hunt-for-fraudulent-icos. Others also argue that SAFT could give rise to investor protection risk, because it "creates a class of early investors that are incentivized to flip their holdings instead of supporting enterprise growth, which could fuel speculation and hurt consumers." Cardozo Blockchain Project, *Not So Fast—Risk Related to the Use of A "SAFT" for Token Sales*, November 21, 2017, at https://cardozo.yu.edu/sites/default/files/Cardozo%20Blockchain%20Project%20-%20Not%20So%20Fast%20-%20SAFT%20Response_final.pdf.

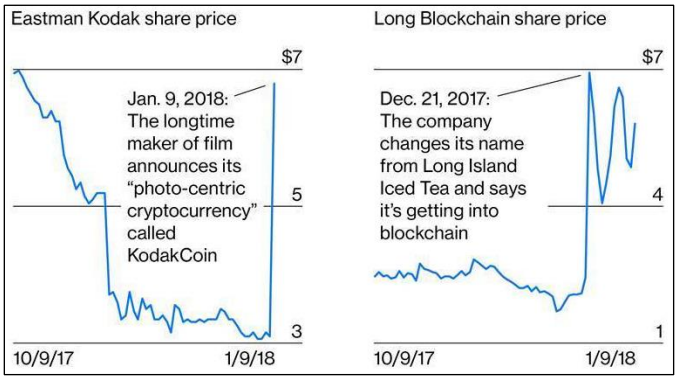
[198] Reuters, "SEC Is Scrutinizing Overnight Blockchain Companies," January 22, 2018, at https://www.reuters.com/article/us-usa-sec-blockchain/sec-is-scrutinizing-overnight-blockchain-companies-chairman-idUSKBN1FB2XI.

[199] Eastman Kodak Company, "KODAK and WENN Digital Partner to Launch Major Blockchain Initiative and Cryptocurrency," January 9, 2018, at https://www.kodak.com/US/en/corp/Press_center/KODAK_and_WENN_Digital_Partner_to_Launch_Major_Blockchain_Initiative_and_Cryptocurrency/default.htm.

[200] Asjylyn Loder, "What's in a Name? For Two Blockchain ETFs, Not the Word 'Blockchain,'" *Wall Street Journal*, January 16, 2018, at https://blogs.wsj.com/moneybeat/2018/01/16/whats-in-a-name-for-two-blockchain-etfs-not-the-word-blockchain.

[201] Long Blockchain received a notification letter from the exchange stating that "the Staff believed that the Company made a series of public statements designed to mislead investors and to take advantage of general investor interest in bitcoin and blockchain technology, thereby raising concerns about the Company's suitability for exchange listing." Long Blockchain Corp. SEC filing, Form 8-K/A, at https://www.sec.gov/Archives/edgar/data/1629261/000149315218002461/form8-ka.htm; and Adam Samson, "Nasdaq Accuses Long Blockchain of Misleading Investors," *Financial Times*, February 22, 2018, at https://www.ft.com/content/ff02c728-17da-11e8-9376-4a6390addb44.

Figure 9. Examples of Rapid Stock Price Increases on ICO- and Blockchain-Related Announcements



Source: Robert Shmidt and Benjamin Bain, "Who Wants to Be Bitcoin's Watchdog?" Bloomberg, January 12, 2018, at https://www.bloomberg.com/news/articles/2018-01-12/who-wants-to-be-bitcoin-s-watchdog.

Regulatory actions concerning ICOs are mixed globally.[202] For example, ICOs have received warning notices by U.S. and European regulators and outright bans in China and South Korea, but have found more support in Switzerland.[203]

Current Volume and Potential

According to CoinDesk ICO Tracker, ICO funding activities started to escalate in 2017. The all-time cumulative ICO funding totaled $19.4 billion as of June 30, 2018, compared to $0.2 billion in mid-2016.[204]

Although ICOs are at present generally considered a method for young private startups to fundraise, some expect the ICO to transform capital formation for large companies as well. One former commissioner of the Commodity Futures Trading Commission (CFTC) speculated that certain large private companies considering IPOs could delay the process with an ICO.[205]

In fact, crypto assets created through ICO and other processes have emerged as a new asset class.[206] According to International Monetary Fund (IMF), crypto asset refers to "digital currencies that rely on encryption techniques to regulate the generation of units and verification of transfers … ICOs are issuances of digital currencies sold via auction or investor subscription in return for crypto assets."[207] This new asset class has received significant attention through rapid

[202] International Organization of Securities Commissions provides a list of global regulators' statements on ICOs at http://www.iosco.org/publications/?subsection=ico-statements.

[203] Dirk A. Zetzsche, Ross P. Buckley, Douglas W. Arner, and Linus Föhr, *The ICO Gold Rush: It's a Scam, It's a Bubble, It's a Super Challenge for Regulators*, University of Luxembourg Law Working Paper No. 11/2017; UNSW Law Research Paper No. 83; University of Hong Kong Faculty of Law Research Paper No. 2017/035, February 18, 2018, at https://ssrn.com/abstract=3072298 or http://dx.doi.org/10.2139/ssrn.3072298.

[204] See CoinDesk ICO Tracker, at https://www.coindesk.com/ico-tracker.

[205] Quotes from Bart Chilton, Former Commissioner at the CFTC. He "speculated that Airbnb, Uber and other big private companies considering initial public offerings to raise money could delay that indefinitely with an ICO." "ICOs, Under Scrutiny from SEC, get Lift from Former Regulator," *PoliticoPRO*, December 2017.

[206] CFTC Chairman J. Christopher Giancarlo characterized crypto assets as a "new asset class" in a keynote speech at a Women in Derivatives event in Washington, DC, titled *Transforming Finance: The Impact of Emerging Technology*, June 12, 2018, documented through CRS attendance.

[207] IMF, *Global Financial Stability Report*, April 2018, at

growth, maturing practices, and regulatory acknowledgement. For example, the Financial Stability Board (FSB) issued a report in July of 2018 to publicize metrics for monitoring the crypto-asset market risk, market capitalization, and institutional exposures, among other factors. The report identifies other asset classes, such as gold and equities, as comparators to crypto assets.[208]

Regulatory Issues

During a testimony in February 2018, SEC Chairman Jay Clayton stated that "the recent proliferation and subsequent popularity of cryptocurrency markets creates a question for market regulators as to whether our historic approach to the regulation of sovereign currency transactions is appropriate for these new markets."[209] The SEC has not yet promulgated ICO-specific rules or exemptions. Some of the most salient ICO-related policy issues are as follows:

- **Regulatory Oversight.** Current U.S. ICO and virtual currency regulation is fragmented, with multiple regulatory approaches at the federal and state levels. The nature of ICO regulation may differ from agency to agency. For example, the SEC has indicated that ICOs may qualify as offerings of "securities," the CFTC treats certain virtual currencies as "commodities," the Internal Revenue Service treats certain virtual currencies as "property," state regulators oversee virtual currencies through state money transfer laws, and the Treasury Department's Financial Crimes Enforcement Network monitors virtual currencies for anti-money-laundering purposes.[210]
- **Enforcement Action.** ICOs may qualify as securities offerings subject to federal regulation. SEC Chairman Clayton was quoted as saying, "I believe every ICO I've seen is a security." Yet no ICOs have been registered as of February 2018 (the first ICO registration was reportedly filed in March 2018),[211] meaning the vast majority of ICO issuers may be violating securities laws. Issuers and investors face a steep learning curve in comprehending the regulatory landscape and in determining how or if securities laws apply to them.
- **Investor Protection.** ICO investors include less-sophisticated retail investors, who may not be positioned to comprehend or tolerate high risks. Investor protection concerns are seen in several areas. First, the high levels of scams and business failures have been a source of concern. One study found that 81% of ICOs are scams and another 11% fail for operational reasons, estimating a 92% combined failure rate for ICO firms.[212] Second, the failure of many ICO

http://www.imf.org/en/Publications/GFSR/Issues/2018/04/02/Global-Financial-Stability-Report-April-2018.

[208] Financial Stability Board, *Crypto-assets Report to the G20 on Work by the FSB and Standard-setting Bodies*, July 16, 2018, at http://www.fsb.org/wp-content/uploads/P160718-1.pdf.

[209] SEC Chairman Jay Clayton, "Testimony on Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission," February 6, 2018, at https://www.sec.gov/news/testimony/testimony-virtual-currencies-oversight-role-us-securities-and-exchange-commission.

[210] CFTC, *Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets*, January 4, 2018, at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf.

[211] Praetorian Group reportedly filed the first ICO registration on March 6, 2018. Renaissance Capital, "Here's a First: The Praetorian Group Files $75 Million ICO With the SEC," March 7, 2018, at https://www.renaissancecapital.com/IPO-Center/News/55377/Heres-a-first-The-Praetorian-Group-files-$75-million-ICO-with-the-SEC.

[212] "According to the ICO advisory firm Satis Group, 81% of ICOs are scams created by con artists, charlatans, and

companies to comply with registration and disclosure associated with traditional securities has been cited as an issue. Without sufficient disclosure, investors would face difficulty understanding the amount of risks they are exposed to. Third, the high volatility of cryptocurrencies' valuations creates large gains and losses. Fourth, the lack of protection through the traditional financial system has also been a concern. The ICO investors are especially prone to new types of fraud and manipulation. For example, although banks have the option to halt or reverse suspicious transactions and associate transactions with user identity, a blockchain transaction is generally irreversible through intermediaries. In addition, cryptocurrencies could be transferred to anonymous criminal accounts. These characteristics were reported as having incentivized new waves of theft involving cryptocurrencies.[213]

- **Trading.** Many cryptocurrency trading platforms are registered as money-transmission services (MTS) instead of national securities exchanges. MTS are money transfer or payment operations that are mainly subject to state instead of federal regulations.[214] Because MTS were not designed for cryptocurrency trading activities, they are said to be inefficient when operating across state lines.[215] In addition, these services raise major investor protection concerns because they are not subject to the same level of regulatory oversight as national securities exchanges.[216] The SEC recently issued a statement clarifying that the online platforms for trading digital assets could be potentially unlawful.[217] In response to increased regulatory attention, numerous crypto exchanges have become federally regulated as of July 2018. For example, one of the largest crypto exchanges, Coinbase, has obtained multiple licenses through acquisitions and is now under SEC and FINRA oversight.[218]
- **Cybersecurity.** Investors risk losing their investments as well as personal information through hacker attacks. One study estimates that more than 10% of ICO proceeds are lost as a result of attacks.[219]

---

swindlers looking to take your money and run. It is also little wonder that only 8% of cryptocurrencies end up being traded on an exchange, meaning that 92% of them fail." NYU Stern Professor Nouriel Roubini, "Initial Coin Scams," May 10, 2018, at http://www.stern.nyu.edu/experience-stern/faculty-research/initial-coin-scams.

[213] Nathaniel Popper, "Bitcoin Thieves Threaten Real Violence for Virtual Currencies," *New York Times*, February 18, 2018, at https://www.nytimes.com/2018/02/18/technology/virtual-currency-extortion.html.

[214] Coin Desk, "What Is Money Transmission and Why Does It Matter?" April 7, 2015, at https://coincenter.org/entry/what-is-money-transmission-and-why-does-it-matter.

[215] Coin Center Report, *The Need for a Federal Alternative to State Money Transmission Licensing*, January 2018, at https://coincenter.org/files/2018-01/federalalternativev1-1.pdf.

[216] A national securities exchange is a securities exchange that has registered with the SEC under §6 of the Securities Exchange Act of 1934. SEC Fast Answers, *National Securities Exchanges*, at https://www.sec.gov/fast-answers/divisionsmarketregmrexchangesshtml.html.

[217] The SEC states that "if a platform offers trading of digital assets that are securities and operates as an 'exchange,' as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration." More details see SEC, "Statement on Potentially Unlawful Online Platforms for Trading Digital Assets," March 7, 2018, at https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

[218] Coinbase President & COO blog post, "Our Path to Listing SEC-regulated Crypto Securities," June 6, 2018, at https://blog.coinbase.com/our-path-to-listing-sec-regulated-crypto-securities-a1724e13bb5a.

[219] EY Research, *Initial Coin Offerings (ICOs)*, December 2017, at http://www.ey.com/Publication/vwLUAssets/ey-research-initial-coin-offerings-icos/%24File/ey-research-initial-coin-offerings-icos.pdf.

- **Scalability.** Current blockchain networks are said to have limited capacity and scalability. For example, major network congestion occurred in November 2017, when the trading of virtual cats, "CryptoKitties," clogged Ethereum. This has led to discussions regarding the fundamental design of blockchain technology, which requires that every transaction be processed by all network nodes, limiting the number of concurrent transactions.[220] New blockchain solutions that could potentially circumvent network congestions have gained traction as measured by the amount of investments attracted. For example, proposed solutions provided by Oasis Labs and Block.one (the developer of the EOS platform) have attracted $45 million through a private token presale[221] and $4.2 billion through an ICO,[222] respectively. But the new blockchains' scalability has not yet been demonstrated in full.

Author Information

Eva Su
Analyst in Financial Economics

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.

[220] Alyssa Hertig, Coindesk, "Loveable Digital Kittens Are Clogging Ethereum's Blockchain," December 7, 2017, at https://www.coindesk.com/loveable-digital-kittens-clogging-ethereums-blockchain. CryptoKitties later became tradable on OPSkins, which is an online-videogame-assets trading platform that is no longer Ethereum-based.

[221] MIT Technology Review, *Chain Letter*, at https://mailchi.mp/technologyreview/chain-letter-764081?e=e3e4435c55.

[222] Paul Vigna, "Investors Bet $4 Billion on a Cryptocurrency Startup," *Wall Street Journal*, at May 29, 2018, at https://www.wsj.com/articles/investors-bet-4-billion-on-a-cryptocurrency-startup-1527591600.