AFL-CIO | AFR Americans for Financial Reform

October 11, 2018

Dear Senator,

On behalf of the AFL-CIO and Americans for Financial Reform (AFR), we are writing to state our opposition to S 488 (the "JOBS and Investor Confidence Act of 2018") which has been passed by the House. We understand that many industry lobbyists are pressing for adoption of some or all of this legislation by the Senate. In our view, S 488 contains a number of harmful deregulatory provisions that make it a bad tradeoff for the public. We are concerned that parts of S 488 meaningfully weaken important investor protections and change the structure of securities markets in damaging ways.

Not all of the provisions in S 488 are misguided. AFR has opposed eleven and supported four of the thirty-two provisions in S 488, and takes no position on the other seventeen.[1] The pro-investor portions of the bill in Titles 27, 29, 30, and 31 do have value, and would shine a light on exploitation of investors and issuers, as well as improper patterns of insider trading tied to stock buybacks. However, these positive provisions are informational measures like studies and advisory provisions. In contrast, other provisions in the bill take much more active steps to deregulate securities markets in ways that could harm investors.

Overall, the package is a net negative for investors and the public interest. It would expose investors to greater danger of fraud, and it would undermine the public equities markets by inappropriately expanding the scope for private fundraising. Some examples of provisions in S 488 that we are concerned about include the following (in order of the titles in the bill):

Title 1 of S. 488, the "HALOS Act", eliminates prohibitions on general solicitation and advertising for Rule 506(b) private securities offerings at "demo days" pitch events sponsored by trade associations and a wide variety of other organizations. After the JOBS Act already vastly expanded the ability to engage in public offerings of private securities, this legislation would expand it even further, permitting large-scale public meetings to pitch private securities to ordinary investors. As University of Mississippi securities law professor Mercer Bullard stated in his recent testimony:[2]

> "The Act will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering. … The HALOS Act represents the de facto repeal of offering regulation."

SEC Rule 506(c) already permits the types of meetings and solicitations authorized by the HALOS Act, but it requires the seller to make a reasonable effort to verify that any purchasers of the offerings are accredited investors. The sole purpose of the HALOS Act seems to be to expand the scope for general solicitation and sales to ordinary retail investors who do not qualify as accredited investors. There is no reason for Congress to act to further deregulate private

[1] AFR has previously opposed Titles 1, 3, 4, 5, 8, 14, 15, 20, and 26 of S 488 as stand alone bills. We opposed a somewhat different version of Title 25 and oppose the version in S 488 due to its interaction with Title 20 (venture exchanges). We opposed a somewhat different version of Title 32 and are still examining the version in S 488. We have previously supported Titles 27, 29, 30, and 31. We take no current position on other provisions.

[2] Bullard, Mercer, "Testimony of Mercer Bullard Before the Committee on Banking, Houseing, and Urban Affairs", June 26, 2018. https://bit.ly/2NBXrB9

securities offerings. Such actions only expose investors to increased risk of fraud and loss while adding to the factors that discourage companies from making public offerings and shrink the public equities market.

Title 3 of the bill creates an "M&A Broker" exception from SEC registration and oversight for firms that assist in buying and selling privately held companies with gross annual revenues of up to $250 million. While a carefully crafted exception for intermediaries in the sale of local small businesses could be appropriate for smaller deals, the $250 million revenue limit in this section far exceeds the size of businesses that are actually local and small. Businesses of this size are better characterized as medium sized to large private businesses with a regional or national footprint. It is unfair to ask brokers who register with the SEC and comply with requirements, including anti-money laundering rules, to compete with unregistered and unregulated competitors in buying and selling private companies of significant size. This legislation could also be harmful to business owners who would sell their businesses through unregistered advisors who are not subject to the codes of ethics that bind registered dealers.

Title 4 cements in statute a definition of "accredited investor" based on income and wealth thresholds that have not changed since 1982 and are far outdated today. In view of the tremendous risk inherent in investing in private securities offerings, the securities laws generally require that persons investing in such offerings be "accredited investors." The current standard, which would be codified by this bill, defines an accredited investor as anyone with a net worth in excess of $1 million excluding their primary residence, or an income in excess of $200,000 (individuals) or $300,000 (couples). This outdated definition effectively removes many Main Street retirees from key transparency and disclosure protections available in the public markets, rendering them more vulnerable to exploitation.[3]

While Title 4 would update the current outdated thresholds for inflation going forward, freezing the current thresholds in statute as the starting point would permanently lock in a dangerously low standard.[4] The accredited investor definition should be revisited but this provision does so in an ill-considered way that would tie the SEC's hands in making needed reforms. Both the SEC's Investor Advisory Committee (IAC) and the North American Association of Securities Administrators (NASAA) oppose this provision and the general idea of placing the current threshold in statute.[5]

Title 8 would require the SEC to rewrite its oversight rules for trading exchanges in ways that would narrow its current authority over exchange pricing practices. Specifically, this section requires the SEC to conduct a new rulemaking that revises its definition of "facility" and

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[3] An estimated one-third of all accredited investors are retirees.

[4] When SEC adopted the current definition of "accredited investor" in 1982 an estimated 1.5 million U.S. households met its requirements. Today, more than 16 million U.S. households—or about one in eight—qualify for accredited status. If the 1982 definition was adjusted to keep pace with inflation, an accredited investor today would need an annual income of $515,000 — well more than double the present $200,000 limit— or a net worth of more than $2.5 million. (https://www.wsj.com/articles/opportunities-to-invest-in-private-companies-grow-1537722023)

[5] See: Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014). Available at http://bit.ly/22HoUHw. North American Securities Administrators Association, "Letter from NASAA President and Alabama Securities Director Joseph P. Borg to the HFSC Chair and Ranking Member regarding markup of H.R. 3758, H.R. 477, H.R. 3857, H.R. 2201, and H.R. 1585", October 11, 2017. Available at http://bit.ly/2xK1Lag .

sets forth the specific facts and circumstances that lead to a determination that any elements or activities of the exchange are a "facility" subject to SEC oversight. The amendment mandates that these facts and circumstances be used to determine if an exchange rule may be reviewed by the SEC and falls under SEC regulatory jurisdiction. Since the definition of "facility" is the key statutory element that gives the SEC jurisdiction over exchanges, the clear goal here is to narrow SEC jurisdiction over trading exchanges.

As officially recognized Self-Regulatory Organizations (SROs), exchanges are granted broad powers by government, which give them significant pricing power and monopoly control over trading information generated on the exchange. Exchanges themselves also have very concentrated ownership, with 12 out of the 13 public stock exchanges owned by just three large corporations. In recent years, these exchanges have become for-profit private corporations and have exercised their regulatory powers aggressively to maximize profits, often at the expense of consumers and investors.[6] In this environment, Congress should avoid taking actions to deregulate these exchanges still further.

Title 14 on international insurance standards would place significant new restrictions on executive branch negotiations of international insurance standards addressing systemic risks posed by international insurance conglomerates. The large insurance conglomerates that dominate the U.S. and global insurance market today are active far beyond the boundaries of any individual state. The Dodd-Frank Act recognizes the importance of state-based insurance regulation and state regulators are currently given a very substantial consultative role in international insurance negotiations. Title 14 increases this role and also puts in place major new barriers to action in this area, including a Congressional fast track veto process for covered agreements that address risk protections for the financial activities of large insurance companies. The Trump White House has already expressed serious concerns about previous measures to restrict international insurance regulatory agreements as contravening executive branch authority.[7] While we do not necessarily agree with this perspective in all cases, we concur that the limitations in Title 14 are excessive and inappropriate.

Title 20 on venture exchanges would dictate an alternative regulatory framework for securities exchanges that list shares of early-stage private startups. A threshold question concerning such venture exchanges is why they are needed. The market for venture capital is already extremely healthy both in the U.S. and globally, reaching new records of approximately $200 billion annually in venture capital funding, with over half in the U.S.[8] Ownership stakes in early stage non-public companies, including venture-funded companies, are already broadly available through over the counter markets to sophisticated individual investors, institutional investors, asset managers, and pension funds that can perform the needed due diligence. Even for these sophisticated investors, the returns from venture investments are highly uncertain and

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[6] https://www.sec.gov/news/speech/jackson-unfair-exchange-state-americas-stock-markets
[7] See Presidential Signing Statement for S 2155, asserting "exclusive Constitutional authority to determine the time, scope, and objectives of international negotiations". Available at http://www.presidency.ucsb.edu/ws/index.php?pid=129721
[8] See KPMG, Venture Pulse: Q1 2018 Global analysis of venture funding, available at: https://home.kpmg.com/xx/en/home/insights/2018/04/venture-pulse-q1-18-global-analysis-of-venture-funding.html

mixed, with venture capital as an asset class generally underperforming the public markets over the long term.[9]

Venture shares tend to be unsuitable for many retail investors due to their risk, and unconducive to exchange listing because they tend to be illiquid and opaque. Increasing liquidity for venture stage investments should not be seen as an end in itself, but should only occur if it serves a real public policy purpose. Greater liquidity might for example be used as a vehicle for informed venture company insiders to exit and sell their investments before bad news about their company reaches the broader public. It would not, for example, have been beneficial if early stage investments in Theranos had been more liquid and company insiders had been able to sell out before the massive fraud at the company had been revealed.

The U.S. public markets are the broadest, deepest, and most liquid in the world, and the success of public markets is most likely to be sustained if companies seeking liquidity are encouraged to go public. Venture exchanges would discourage this. They also risk creating the appearance but not the reality of liquidity, as shares in early stage venture companies with limited information and disclosure are always likely to be thinly traded.

Title 25 on venture capital funds would further encourage excessive secondary market trading in venture shares by permitting companies to qualify for venture capital exemptions from SEC rules by trading secondary stakes in venture capital companies. This would effectively allow venture capital funds to become quasi-mutual funds made up of secondary shares in venture capital companies. The public purpose that would be served by this provision is unclear.

Again, the pro-investor studies and advisory bodies in Titles 27, 29, 30, and 31 of S 488 do have value. However, they do not outweigh the harm that would be done by the provisions cited above, which would actively change securities laws in significant ways. On balance, there is simply no reason for Congress to act to grant the benefits to industry contained in this bill.

Thank you for your attention. For more information please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform

[9] Mulcahy, Diane and Weeks, Bill and Bradley, Harold S, "We Have Met the Enemy…and He is Us: Lessons from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and the Triumph of Hope Over Experience", Kauffman Foundation, May 2012. Available at SSRN: https://ssrn.com/abstract=2053258