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United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Comment on File Number S7-05-20

Dear Securities and Exchange Commission:

In response to your Proposed Rule on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets (File No. S7-05-20), I offer the following comments, broken out into two parts. In Part I, I will make general comments that relate to the entire Proposed Rule. In Part II, I will present specific comments relating to Regulation Crowdfunding that build on the comments I provided in my September 24, 2019, comment letter on the Concept Release on Harmonization of Securities Offering Exemptions (File No. S7-08-19).[1] On the whole, I support the Proposed Rule and encourage you to adopt it. In my comments below, I recommend that you go even further with your liberalization of the exempt offering framework.

Part I: Voluntary Disclosure for Primary Offerings[2]

Mandatory disclosure—the idea that companies must be legally required to disclose certain, specified information to public investors—is the first principle of modern securities law, including the Proposed Rule. Despite the high costs it imposes, mandatory disclosure has been well defended on two theoretical grounds: 'agency costs' and 'information underproduction.' While these two concepts are a good fit for secondary markets (where investors trade securities with one another), they are largely irrelevant in the context of primary markets (where companies offer securities directly to investors), as I demonstrated in a recent article.[3] Based on this analysis, I believe that primary offerings—including all of those covered by the Proposed Rule—may not require mandatory disclosure at all.[4]

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[1] My September 24, 2019, comment letter was cited in the Proposed Rule on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets (File No. S7-05-20) (in footnotes 149, 292, 294 and 296), as well as in Commissioner Peirce's Statement on Proposed Amendments for Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets (in footnote 2), dated March 4, 2020.

[2] This Part is adapted from my March 3, 2020, post on the Columbia Law School Blue Sky Blog, which was itself based on my recent article, Andrew A. Schwartz, *Mandatory Disclosure in Primary Markets*, 2019 UTAH LAW REVIEW 1069. Notably, this article was among the 'Top Ten' most-downloaded articles on Securities Law when it was posted to SSRN, and has attracted significant attention from commentators, including Professor Stephen Bainbridge of UCLA Law School, who wrote on his widely read blog, "Andrew Abraham Schwartz has posted a very interesting new paper, which I think advances the ball significantly in the seeming dormant debate over mandatory disclosure. . . . Highly recommended."

[3] Andrew A. Schwartz, *Mandatory Disclosure in Primary Markets*, 2019 UTAH LAW REVIEW 1069.

[4] *Accord* Coffee, 70 VA. L. REV. at 746 (acknowledging that "the theory of voluntary disclosure does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all primary distributions"); *see also* Alan

In my recent article,[5] I take up the big question of whether mandatory disclosure is actually needed, or whether voluntary disclosure would be preferable. After all, corporate promoters wishing to sell securities for their full value already have an economic incentive to voluntarily provide information to potential investors; otherwise they would receive only a pittance per share. Furthermore, mandatory disclosure is so expensive that it now costs millions of dollars to file for an IPO, with the result that startups and small businesses may not be able to afford to go public. Even the more limited disclosures mandated by the various exemptions covered by the Proposed Rule impose significant costs on issuers, reducing the net amount of capital they can raise, or deterring them from even trying in the first place.

The original rationale of mandatory disclosure, dating back to the federal Securities Act of 1933, was to treat retail investors fairly by providing them with accurate and timely information about potential and actual investments. But anyone who has actually looked at a securities filing knows that they are so arcane and densely written as to be almost impenetrable to an ordinary retail investor. Similarly, no one seriously argues that our large public companies would not provide any information to the public absent legally mandated disclosure. This is due to the economic concept of signaling, which suggests, at its most basic, that companies have an incentive to disclose even bad news because, if they stay silent, investors will presume that things are even worse. Hence, over time, both the fairness rationale and fear of no disclosure have fallen out of favor among scholars and policymakers.

In its place, modern scholars, led by Professor John Coffee, have set forth a pair of sophisticated law-and-economics defenses of mandatory disclosure: (1) agency costs and (2) information underproduction.[6] Agency costs occur when corporate managers pay themselves extravagantly, work as little as possible, or even steal from the company, all to the detriment of investors. Under a regime of voluntary disclosure, where managers of a corporation are given free rein to decide what the company will and won't disclose, they might decide to keep quiet about things that paint them personally in a bad light, even if the information would be relevant to investors. Mandatory disclosure can solve this problem by requiring companies to share information about managerial misbehavior, even if it leads the stock price to fall. Mandatory disclosure also discourages bad behavior, as managers police their own actions to avoid having to provide embarrassing disclosure later on.

As for information underproduction, the idea is that companies will rationally decline to expend resources to voluntarily collect and disclose information that could be relevant to the value of other firms – even if investors would prefer disclosure. McDonald's, which sells lots of soft drinks, presumably has information relevant to the accurate pricing of Coca-Cola stock, but it has no interest in tallying and reporting Coke sales because McDonald's would suffer all the costs, while Coca-Cola's investors would receive all the benefit (in the form of more accurate pricing). Mandatory disclosure can remedy this problem by forcing all public companies to share certain types of information, thereby enhancing the accuracy of all securities.

The modern theory of mandatory disclosure, premised on these two concepts, has achieved hegemony in the field. Nearly all scholars support the idea, both in the United States

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R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 128–29 (1999) (suggesting that the modern theory in favor of mandatory disclosure is "flawed" because it "assumes market failure without distinguishing between primary and secondary markets").

[5] Andrew A. Schwartz, *Mandatory Disclosure in Primary Markets*, 2019 UTAH LAW REVIEW 1069.

[6] John C. Coffee, Jr., *Market Failure and the Economic Case for A Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984) (canonical exposition of the modern theory of mandatory disclosure).

and around the world, and only a very few academic skeptics – including Roberta Romano and Paul Mahoney – continue to hold out in favor of voluntary disclosure.

Almost entirely overlooked in the discussion, however, and a potential ground for reconciliation among these competing camps, is the simple distinction between primary markets and secondary markets. The two key economic concepts that undergird the modern theory of mandatory disclosure – agency costs and information underproduction – make good sense in the context of secondary markets. But if we shift our gaze to the primary context, these two ideas become largely irrelevant.

First, agency costs arise only after the securities have been sold and the investors worry that management will run the company in its own interest, rather than for the benefit of shareholders. The concept is irrelevant to the primary market, where promoters are trying to get investors to buy the securities at the outset. In the primary market, there are no agents and hence no agency costs; they are a feature of the secondary market alone.

Second, information underproduction is largely a function of the secondary market only. The idea here is that one company may have relatively easy access to information that would help participants in the secondary market more accurately assess the value of some other company or companies whose securities they trade. Information underproduction has almost nothing to do with primary offerings, because new issuers rarely have the same quantity or quality of relevant market information as existing public companies, and because a primary offering is a one-time event. Furthermore, promoters have powerful economic interests to divulge all the information that investors want, and thus there is likely little relevant company information missing from public view.

This analysis poses a direct theoretical challenge to the dominant view that mandatory disclosure—and its costs—are justified in the context of primary offerings. The Proposed Rule relates entirely to primary offerings and has no impact on secondary markets. The purpose of the Proposed Rule is to 'facilitate capital formation and investment opportunities,' and has nothing whatsoever to do with trading—indeed, most of the types of offerings that it covers impose significant restrictions on resale.

I therefore recommend removing entirely any and all disclosure mandates for all of the exempt offerings covered by the Proposed Rule, including Regulation A, Regulation D and Crowdfunding, so as to allow companies to voluntarily disclose an efficient amount of the sort of information that investors actually want. By minimizing the cost of raising capital, this move has the potential to significantly increase the amount of capital raised, and the number of companies that are funded—which is the goal of the entire exercise.

Part II: Further Liberalize Crowdfunding

Crowdfunding has the potential, to quote President Obama, to be a "game changer" for startups and small businesses—but it is not yet there. Regulation Crowdfunding offers an exciting opportunity for retail investors to participate in private offerings that are currently offered only to accredited investors, and for entrepreneurs of all stripes to obtain the capital they need. But because issuers can only raise a small amount via crowdfunding, the system can only work if the legal framework is simple and the regulatory burden light. Our current system for equity crowdfunding is complex and overregulated, however, with the result that very few issuers or investors are participating in the market. We can do better.

As I explained in my comment letter of September 24, 2019, New Zealand's lightly regulated system of investment crowdfunding provides a model for us to follow in the United States.[7] The Proposed Rule goes much of the way towards the liberal model I advocate, as does the Temporary Rule you put into place earlier this month, and I fully support the changes you made in both—but I recommend that you go even further.

In my prior comment letter, I made five specific recommendations for reforming Regulation Crowdfunding:

(1) Increase the annual offering limit to $5 million;
(2) Eliminate individual investment limits for accredited investors;
(3) Simplify the individual investment limit to $5,000 per investment;
(4) Permit any and all advertising and general solicitation;
(5) Simplify or eliminate Form C and the disclosures for which it calls.

I thank you and give you credit for adopting the first two recommendations in the Proposed Rule. Well done. As for the third recommendation, I appreciate your change to the 'greater of' test for individual investment limits (although I have some misgivings on this point, as I explained in a prior comment letter on File No. S7-09-13, dated January 27, 2014). In addition, you made some headway towards the fourth recommendation by allowing issuers to 'test the waters' before a Form C is filed, a move I applaud.

This leaves only my fifth recommendation, to eliminate Form C entirely and allow issuers to voluntarily disclose information in a manner that best suits the company and its potential investors. As I explained in Part I above, while mandatory disclosure may be useful and even necessary in the context of secondary trading markets, it is neither useful nor necessary for primary offerings, like those made under Regulation Crowdfunding. Even with the new $5 million cap on offerings, compliance costs must be kept to a minimum for crowdfunding to be a viable option for issuers. Eliminating Form C would be a bold and direct way to get there, and I recommend that you do so. Importantly, there is every reason to expect that issuers will still provide ample disclosure to investors if you eliminate Form C—they will just do so voluntarily, and in a manner that makes sense for the situation, as the experience in New Zealand, which I described in my prior letter and several law review articles,[8] has shown.

Thank you,

Andrew A. Schwartz

[7] Among the major differences between Regulation Crowdfunding and its counterpart in New Zealand:

- New Zealand has no mandatory disclosure and no equivalent to 'Form C';
- New Zealand has no individual investment limits;
- New Zealand has no restrictions on advertising.

[8] Andrew A. Schwartz, *The Gatekeepers of Crowdfunding*, 75 WASH. & LEE L REV. 885 (2018); Andrew A. Schwartz, *Equity Crowdfunding in New Zealand*, 2018 N.Z. L. REV. 243.