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Killing the Goose That Laid the Golden Eggs: How Pervasive Securities Regulation Strangles Small High Tech Medical Instrument Companies

Danny Ljungberg

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ABSTRACT

Since the infamous "Black Tuesday" Wall Street Crash of 1929, there has been a multitude of federal and state legislation and regulation designed to protect the financial markets and the individual investor from fraud and manipulation. The Securities Act of 1933 and the Securities Exchange Act of 1934 were the earliest significant enactments. Since then, the most onerous Acts have been the Investment Company Act of 1940, Investment Advisers Act of 1940, Sarbanes-Oxley Act of 2002, and Dodd–Frank Wall Street Reform and Consumer Protection Act. While these Acts have admirable goals and intentions, together they have the unintended consequence of choking investment in smaller innovative companies by imposing too onerous reporting and disclosure requirements that make it impractical for the companies to "go public". Several aspects of these Acts, coupled with their Securities and Exchange Commission ("SEC") enabling rules, significantly impact small high growth businesses – who drive the majority of innovation – by reducing the number of investors, increasing compliance costs, or dissuading investors from investing.

This article will examine the regulatory environment in which small high tech medical instrument companies operate and provide three solutions to the problem of the overly burdensome reporting and disclosure requirements. Part I is an introduction. Part II gives an overview of the major statutes affecting the ability of innovative companies to raise money by soliciting investment from the general public. Part III discusses the impact of pervasive reporting and disclosure requirements on small businesses. Part IV discusses recent legislation and

regulation designed to improve the ability of small companies to raise money by soliciting investment from the general public; specifically, the “Smaller Reporting Company” exemption, the “Emerging Growth Company” exemption, and the JOBS Act (including title III, known as the “CROWDFUND Act”). Part V proposes three solutions to temper the overly burdensome reporting and disclosure requirements: (1) an exemptive relief order issued by the SEC that relieves some of the reporting and disclosure requirements for small innovative companies; (2) a potential business model that allows small high tech medical instrument companies to access capital from the general public and in turn allows small retail investors to participate in an investment area with the highest potential for growth; and (3) proposed SEC rules and regulations for implementing the CROWDFUND Act.

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I. INTRODUCTION

America is widely known for its culture of invention and innovation. Our Constitution even assigns Congress "[t]o promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries[.]"[1] Thomas A. Edison is one such example of American innovation as he made significant advancements in the light bulb and motion pictures, and invented the phonograph.[2] He also received 1,093 US patents.[3]

Innovation is a key driver of economic growth. It improves public welfare and allows people to live longer, healthier lives. Innovation drives new products and production methods. Initial public offerings ("IPOs") can provide the funds necessary to develop the new products and production methods or bring them to market. When Microsoft went public in 1986 and Apple went public in 1980, their IPOs were valued at $65 million and $101.2 million, respectively.[4] Adjusted for inflation, these IPOs would be valued at $138.51 million[5] and $286.83 million,[6] respectively, in 2013 dollars.

In recent years, however, we have seen an alarming trend of companies waiting longer before going public. Four of the largest IPOs by value in United States history all happened in

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[1] U.S. Const. art. I, § 8, cl. 8
[2] Thomas Edison, http://en.wikipedia.org/w/index.php?title=Thomas_Edison&oldid=584901412 (last visited Dec. 8, 2013).
[3] *Id.*
[4] See Richard E. Rustin & Mitchell C. Lynch, *Apple Computer Set to Go Public Today; Massachusetts Bars Sale of Stock as Risky*, WALL ST. J., Dec. 12, 1980, at 5, *available at* http://online.wsj.com/public/resources/documents/AppleIPODec12_1980_WSJ.pdf; Todd Bishop, *Looking back: Microsoft IPO, March 1986*, SEATTLE PI, (Mar. 16, 2006), http://blog.seattlepi.com/microsoft/2006/03/16/looking-back-microsoft-ipo-march-1986/.
[5] CPI Inflation Calculator, BUREAU OF LABOR STATISTICS, (last visited Dec. 8, 2013), http://data.bls.gov/cgi-bin/cpicalc.pl?cost1=65&year1=1986&year2=2013.
[6] CPI Inflation Calculator, BUREAU OF LABOR STATISTICS, (last visited Dec. 8, 2013), http://data.bls.gov/cgi-bin/cpicalc.pl?cost1=101.2&year1=1980&year2=2013.

the last five years (2008 – 2012).[7] This trend causes public investors to lose out on the early growth of a company and damages the companies by forcing them to deal only with a smaller number of investors who have increased bargaining power.

Since the infamous "Black Tuesday" Wall Street Crash of 1929, there has been a multitude of federal and state legislation and regulation designed to protect the financial markets and the individual investor from fraud and manipulation. The Securities Act of 1933 ("the '33 Act") and the Securities Exchange Act of 1934 ("the '34 Act") were the earliest significant enactments. Since then, the most onerous Acts have been the Investment Company Act of 1940 ("Investment Company Act"), Investment Advisers Act of 1940 ("Investment Advisers Act"), Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), and Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). While these Acts have admirable goals and intentions, together they have the unintended consequence of choking investment in smaller innovative companies by imposing too onerous reporting and disclosure requirements that make it impractical for the companies to "go public". Several aspects of these Acts, coupled with their Securities and Exchange Commission ("SEC" or "Commission") enabling rules, significantly impact small high growth businesses – who drive the majority of innovation – by reducing the number of investors, increasing compliance costs, or dissuading investors from investing.

The SEC has promulgated Regulation A ("Reg. A"), which can exempt small businesses from both the registration requirements of the '33 Act and the reporting requirements of the '34 Act.[8] Companies have utilized the Reg. A exception only 78 times between 1995 and 2004, and

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[7] Initial public offering, http://en.wikipedia.org/w/index.php?title=Initial_public_offering&oldid=584711825 (last visited Dec. 8, 2013). Those IPOs are: American International Assurance in 2010 and valued at $20.5 billion; Visa Inc. in 2008 and valued at $19.7 billion; General Motors in 2010 and valued at $18.15 billion; and Facebook, Inc., in 2012 and valued at $16 billion. *Id.*

[8] 17 C.F.R. §§ 230.251-230.263 (2013).

only three times in 2010.[9] There has been a significant decline in the numbers of small IPOs. More companies are electing to stay private while other public companies are electing to go private through acquisitions or management buy-outs.[10]

In the genetics and biomedical research fields, it can be extraordinarily difficult to attract interest in a private placement. Large, accredited investors want relatively certain returns and a predictable timeline. Research in these areas can be extremely expensive, risky, and have long incubation cycles. This leads to an inability for companies to attract large, accredited investors. Retail investors and charitable trusts are excellent candidates for investing in these types of businesses because they can better tolerate a certain degree of uncertainty. Additionally, investing in research allows people to feel good about their investments. For example, it would be particularly hypocritical for an endowment supporting the American Cancer Society to be invested in Altria Group Inc., the parent company of Philip Morris. It would be much more palatable for the endowment to be invested in a small company developing improved cancer screening methods.

This article will examine the regulatory environment in which small high tech medical instrument companies operate and provide three solutions to the problem of the overly burdensome reporting and disclosure requirements. Part I is an introduction. Part II gives an overview of the major statutes affecting the ability of innovative companies to raise money by soliciting investment from the general public. Part III discusses the impact of pervasive reporting and disclosure requirements on small businesses. Part IV discusses recent legislation and

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[9] H.R. Rep. No. 112-206 at 3 (2011).

[10] *Id.* A recent example of a company considering a "going private transaction" is the potential sale of Blackberry to Fairfax Financial. Will Connors, *BlackBerry Strikes Preliminary Go-Private Deal for $4.7 Billion*, WALL ST. J., (Sept. 23, 2013 7:55 p.m.), http://online.wsj.com/news/articles/SB10001424052702303759604579093342883899478.

regulation designed to improve the ability of small companies ability to raise money by soliciting investment from the general public; specifically, the "Smaller Reporting Company" exemption, the "Emerging Growth Company" exemption, and the JOBS Act (including title III, known as the "CROWDFUND Act"). Part V proposes three solutions to temper the overly burdensome reporting and disclosure requirements: (1) an exemptive relief order issued by the SEC that relieves some of the reporting and disclosure requirements for small innovative companies; (2) a potential business model that allows small high tech medical instrument companies to access capital from the general public and in turn allows small retail investors to participate in an investment area with the highest potential for growth; and (3) proposed SEC rules and regulations for implementing the CROWDFUND Act.

II. SUMMARY OF STATUTES IN PLAY

Congress debated two remedies in the wake of the Wall Street Crash of 1929. One remedy was to have an agency determine whether or not potential new securities seeking permission to be sold to the general public were good investments. The other remedy was to require enough disclosure to permit investors to make their own informed decisions as to whether the securities were good investments.[11] Congress, and most states, chose to go down the second avenue of disclosure.

Initially, Congress enacted the '33 Act, which governs primary market transactions. "Primary market transactions" are also known as "public offerings" and occur when a company issues and sells securities not previously in existence directly to the general public.[12] If a company issues and sells securities directly to the general public for the first time, it is an "Initial

[11] *See* Deepa Sarkar, *Why Securities Laws?*, CORNELL LAW SCHOOL SECURITIES LAW CLINIC (last visited Dec. 8, 2013), http://www.law.cornell.edu/wex/securities_law_history.
[12] Public Offering, http://legal-dictionary.thefreedictionary.com/public+offering (last visited Dec. 8, 2013).

Public Offering" or "IPO".[13] If this is not a first issuance and sale of securities directly to the general public, then it is a "Secondary" or "Follow-on Offering".[14]

A little more than a year later, Congress enacted the '34 Act, which governs "secondary market transactions" or transactions between shareholders and would-be shareholders, such as when existing securities are purchased through a broker. Most people are familiar with this type of transaction; for example, purchasing stock of a well-known company through a broker such as E*Trade. The '34 Act created the SEC and authorized it to promulgate regulations and to enforce the Act and implementing regulations. The '34 Act also governs broker/dealers, exchanges, and self-regulatory organizations; and it requires continuing disclosure for public companies, that is, companies that have issued shares to the public through a public offering.

Congress has amended the '34 Act with two additional pieces of legislation: the Sarbanes-Oxley Act and Dodd-Frank. These amendments created stricter continuing disclosure requirements for public companies. With the '33 Act and the '34 Act, Congress did not intend to substitute its judgment for that of the individual investor.[15] With the Sarbanes-Oxley and Dodd-Frank Acts, however, Congress did just that by creating too heavy a burden on small innovative companies and causing them to be unable to become public companies. This unintended consequence prevents an individual investor from determining where his or her money should be invested.

The Investment Company Act governs investment companies in all aspects and requires specific internal controls and registration with the SEC. An example of an investment company

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[13] Initial Public Offering, http://financial-dictionary.thefreedictionary.com/initial+public+offering (last visited Dec. 8, 2013).
[14] Secondary Offering, http://financial-dictionary.thefreedictionary.com/secondary+Offering (last visited Dec. 8, 2013).
[15] *See* Deepa Sarkar, *Why Securities Laws?*, CORNELL LAW SCHOOL SECURITIES LAW CLINIC (last visited Dec. 8, 2013), http://www.law.cornell.edu/wex/securities_law_history.

is a mutual fund. The Investment Advisers Act governs investment advisers, meaning, those companies or people that manage money on behalf others or provide investment advice for a fee.

Congress enacted these Acts pursuant to its authority under the Commerce Clause. All four Acts apply only when the transactions are effected using the mails or other instrumentalities of interstate commerce.[16] They are designed to be enabling Acts for the SEC to exercise its authority and otherwise they have absolutely no binding provisions.[17] In addition, the Acts set the floor and ceiling of the SEC's authority but provide liberal latitude and deference to the agency. In some cases, the Acts even give the SEC the explicit authority to ignore statutory provisions.[18]

There is a fine line between regulation necessary to protect investors and allowing appropriate access to capital for growing companies. Congress acknowledged this fine line in two ways. First, in some of its amendments to the '33 Act specifically exempting emerging growth companies from certain provisions. Second, in enacting the Small Business Investment Incentive Act of 1980, which requires the SEC to host an annual Government-Business Forum on Small Business Capital Formation.

A. Securities Act of 1933

The '33 Act[19] was the first federal regulation of securities. It focused on the regulation of offers or sales of securities utilizing the mails or any means of interstate commerce.[20] For offerings to the public, such as IPOs, the '33 Act generally requires the company issuing the securities ("issuer") to file a registration statement that includes the following: issuer's name,

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[16] *See generally* 15 U.S.C. § 77a *et seq.*; 15 U.S.C. § 78a *et seq.*; 15 U.S.C. § 80a-1 *et seq.*; 15 U.S.C. § 80b-1 *et seq*.
[17] *Id.*
[18] *Id.*
[19] 15 U.S.C. § 77a *et seq*. (2013).
[20] Small Business and the SEC, http://www.sec.gov/info/smallbus/qasbsec.htm, (last visited Dec. 8, 2013) [hereinafter *Small Business and the SEC*].

officers, directors, and all shareholder owning more than 10% as well as the amount of the issuer owned by each; any and all current securities issued by the issuer that are currently owned by anyone other than the issuer ("securities outstanding"); a description of the type and nature of the business the issuer engages in; a description of what the funds being raised by the sale of the securities that are the subject of the registration statement will be used for; and three years worth of financial statements that have been audited by an independent certified accountant registered with the Public Company Accounting Oversight Board ("PCAOB").[21]

The '33 Act delegates the responsibility for ensuring compliance to the SEC.[22] Originally, this responsibility was delegated to the Federal Trade Commission. The '34 Act transferred responsibility to the SEC 60 days after the majority of the commissioners had taken office,[23] although this wasn't reflected in the definitions until 1987.[24] After receiving the registration statement, the SEC staff reviews it to ensure that it discloses all of the required information.[25] The SEC does not opine on the investment merits of the offering or the suitability to any particular type of investor.[26] After review, the Commission declares the registration statement to be "effective". This allows the company to sell the securities to public investors.

Under certain conditions, securities may be offered or sold without SEC registration under the '33 Act.[27] Even with a registration exemption, all offers or sales of securities are still subject to the antifraud provisions of the Act.[28] The most common exceptions to the registration

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[21] Form S-1, http://www.sec.gov/about/forms/forms-1.pdf, (last visited Dec. 8, 2013).
[22] Small Business and the SEC, *supra* note 20.
[23] Securities Exchange Act of 1934 § 210, 48 Stat. 881 (1934).
[24] Securities and Exchange Commission Authorization Act of 1987, Pub. L. No. 100–181 § 201, 101 Stat. 1249 (1987).
[25] Small Business and the SEC, *supra* note 20.
[26] *Id.*
[27] *Id.*
[28] *Id.*

requirement are: the private placement exemption – Regulation D (“Reg. D”)[29]; small offering exemption – Reg. A[30]; intrastate offering exemption – Rule 147 provides the “safe harbor”[31]; sales of securities through employee benefit plans exemption – Rule 701[32]; and resale of restricted securities exemption – Rule 144[33]. The Reg. D private placement exemption is the exception most commonly used to sell securities to venture capitalists. It allows companies to sell securities to “accredited investors” without a registration. An accredited investor includes: registered investment companies; persons with a net worth exceeding $1,000,000; persons with an annual income exceeding $200,000 or joint income with spouse exceeding $300,000 in each of the last two years with a reasonable expectation of such income in the future; and directors, officers, or general partners of the company selling the securities.[34] Under the Reg. A small offering exemption, a company may raise up to $5,000,000 in any 12-month period through the sale of securities to the general public without registering with the SEC.[35] Under the intrastate offering exemption, a company that only sells or offers to sell securities to residents of its own state is not required to register with the SEC.[36] SEC rule 147 provides specific guidelines as to how to take advantage of the intrastate offering exemption.[37] The sales of securities through employee benefit plans exemption allows a company to offer securities to its own employees as compensation.[38] The resale of restricted securities exemption allows current holders of

[29] 17 C.F.R. §§ 230.500-230.508 (2013).
[30] 17 C.F.R. §§ 230.251-230.263 (2013).
[31] 17 C.F.R. § 230.147 (2013).
[32] 17 C.F.R. § 230.701 (2013).
[33] 17 C.F.R. § 230.144 (2013).
[34] 17 C.F.R. § 230.501(a) (2013).
[35] 15 U.S.C. § 77c (b)(1) (2013); 17 C.F.R. §§ 230.251-230.263 (2013).
[36] 15 U.S.C. § 77c (a)(11) (2013).
[37] 17 C.F.R. § 230.147 (2013).
[38] 17 C.F.R. § 230.701 (2013).

unregistered securities to sell those securities provided they follow the specific requirements of SEC rule 144.[39]

The '33 Act also grants the SEC the power to promulgate rules, regulations, and orders in addition to granting the Commission general exemptive authority to exempt any person or entity or any transaction from almost any requirements under the Act.[40] The Act specifically provides that

> [t]he Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.[41]

B. Securities Exchange Act of 1934

The '34 Act[42] is the most comprehensive and voluminous act that governs access to capital. The '34 Act governs secondary market transactions.[43] Additionally, it created the SEC and empowered it to implement any regulation necessary in the public interest or for the protection of investors and to enforce its own rules, regulations, and orders. It also set requirements for broker/dealers, national exchanges, and created the self-regulatory organizations.[44]

The '34 Act requires public companies and certain companies that meet specified thresholds to regularly submit information about their management, financial condition, and operations to the SEC.[45] Public companies are companies that have issued shares to the public

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[39] 17 C.F.R. § 230.144 (2013).
[40] 15 U.S.C. § 77s (2013).
[41] 15 U.S.C. § 77z-3 (2013).
[42] 15 U.S.C. § 78a *et seq*. (2013).
[43] Small Business and the SEC, *supra* note 20.
[44] 15 U.S.C. § 78o-3 (2013).
[45] 15 U.S.C. § 78m (2013).

through a public offering or are required to register under Section 12 of the '34 Act.[46] Companies engaged in interstate commerce or in a business affecting interstate commerce or whose securities are offered or sold using the mails or instruments of interstate commerce with more than 500 non accredited investor shareholders or 2000 shareholders of a class of securities and more than $10 million in assets for each of the last 3 years are required to register and provide periodic reports and disclosures.[47] When the Commission declares a company's registration statement to be effective, the company is considered to be a public company and is required to comply with the reporting requirements of the '34 Act.[48] Public companies are required to file an annual report on Form 10-K.[49] Public companies must file quarterly reports on Form 10-Q.[50] These companies also must continuously disclose certain events, known as current reports, on Form 8-K.[51]

Once a company is subject to the reporting requirements ("reporting company") of the '34 Act, it must file most of the same information that it has already filed in the registration statement when it files its Form 10-K and Form 10-Q reports.[52] The Sarbanes-Oxley Act amended the '34 Act and made these periodic reports more time consuming by putting the onus on the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") to verify that the financial information, as well as other aspects of the periodic reports, is complete and

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[46] 15 U.S.C. § 78l (2013).
[47] 15 U.S.C. § 78l(g)(1) (2013).
[48] 15 U.S.C. § 78l (2013).
[49] Form 10-K is an annual report form.15 U.S.C. § 78m(a)(2) (2013); 17 C.F.R. § 240.13a-1 (2013); 17 C.F.R. § 249.310 (2013).
[50] Form 10-Q is a quarterly report form.15 U.S.C. § 78m(a)(1) (2013); 17 C.F.R. § 240.13a-13 (2013); 17 C.F.R. § 249.308a (2013).
[51] Form 8-K is a current report form.15 U.S.C. § 78m(a)(1) (2013); 17 C.F.R. § 240.13a-11 (2013); 17 C.F.R. § 249.308 (2013).
[52] 15 U.S.C. § 78m (2013); 17 C.F.R. § 240.13a-1 (2013); 17 C.F.R. § 249.310 (2013); 17 C.F.R. § 240.13a-13 (2013); 17 C.F.R. § 249.308a (2013); 17 C.F.R. § 240.13a-11 (2013); 17 C.F.R. § 249.308 (2013).

accurate.[53] It also imposed civil and criminal penalties on any person who signs the periodic reports.[54] Additionally, the Sarbanes-Oxley Act requires controls to be in place to ensure the accuracy of financial reports.[55] All reporting companies must file a current report on Form 8-K in the event of a material event within four days after the event.[56] Some examples of material events are: entry into and termination of merger or sale agreement, completion of acquisition or sale of assets, notice of delisting, unregistered sale of equity securities, changes in independent accountant, changes in control, changes in the officers or board of directors, etc.[57] Once a company has been subject to the reporting requirements it must continue to report until the company has fewer than 300 shareholders of the class of securities or the company has fewer than 500 shareholders of the class of securities and less than $10 million in assets for each of the last 3 years.[58]

The '34 Act also grants general exemptive authority to the SEC to exempt any person or entity or any transaction from almost any requirements under the act.[59] The Act specifically provides that

> notwithstanding any other provision of this chapter, the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.[60]

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[53] 15 U.S.C. § 7241(2013); 17 C.F.R. § 240.13a-15 (2013).
[54] 18 U.S.C. § 1350 (2013).
[55] 15 U.S.C. § 7241 (2013).
[56] 15 U.S.C. § 78m(a)(1) (2013); 17 C.F.R. § 240.13a-11 (2013); 17 C.F.R. § 249.308 (2013).
[57] Small Business and the SEC, *supra* note 20.
[58] 17 C.F.R. § 240.12g-4 (2013).
[59] 15 U.S.C. § 78mm (2013).
[60] *Id.*

C. Investment Company Act of 1940

The Investment Company Act[61] governs investment companies.[62] An investment company is a company that "is or holds itself out as being engaged primarily…in the business of investing, reinvesting, or trading in securities."[63] The most widely known example of an investment company is a mutual fund.[64] It requires most investment companies to register with the SEC.[65] The Act also requires a board of directors that is independent of the investment adviser.[66]

The Act empowers or requires the Commission to promulgate rules, regulations, and orders under the various sections of the act.[67] It grants the SEC limited exemptive power under individual sections. However, among the powers delegated to the Commission is the power to declare that a company is not subject to it for any reason if it is in the public interest or for the protection of investors.[68]

D. Investment Advisers Act of 1940

The Investment Advisers Act[69] governs investment advisers.[70] An investment adviser is any person or entity that provides investment advice for compensation, unless the entity is a bank or certain professionals and the advice is incidental to their other business.[71] The Act requires most investment advisers to register with the SEC.[72] The Act empowers or requires the

[61] 15 U.S.C. § 80a-1 *et seq*. (2013).
[62] 15 U.S.C. § 80a-1 (2013).
[63] 15 U.S.C. § 80a-3 (2013).
[64] Mutual Fund, http://legal-dictionary.thefreedictionary.com/Mutual+Fund, (last visited Dec. 8, 2013).
[65] 15 U.S.C. § 80a-8 (2013).
[66] 15 U.S.C. § 80a-15 (2013).
[67] 15 U.S.C. § 80a-37 (2013).
[68] *Id.*
[69] 15 U.S.C. § 80b-1 *et seq*. (2013).
[70] 15 U.S.C. § 80b-1 (2013).
[71] 15 U.S.C. § 80b-2 (2013).
[72] 15 U.S.C. § 80b-3 (2013).

Commission to promulgate rules, regulations, and orders under the various sections of the Act. The Act also grants the SEC general exemptive authority to exempt any person or entity or any transaction from almost any requirements under the act if it is in the public interest or for the protection of investors.[73]

III. IMPACT OF REGULATION ON SMALL HIGH TECH MEDICAL INSTRUMENT COMPANIES

Small high tech companies offer the largest possibility for real economic growth and job creation in the United States.[74] While venture capital investments constitute only 0.1%-0.2% of the US Global Domestic Product ("GDP"), companies that were backed by venture capitalists account for 11% of US private sector employment and 21% of the US GDP.[75] Experts agree that most of the medical device breakthroughs and nearly the entire biotechnology field would not exist without venture capital.[76] Venture-backed life sciences companies have developed products and innovations that have positively impacted one in three Americans.[77]

In the past, venture capital has been crucial to the development of new medical technology. From 1980-2012, venture capitalists invested $108 billion in 4,600 life sciences startups.[78] This accounts for 19% of all venture capital investment during that time frame.[79] However, venture capital investment in life sciences is decreasing at a rapid rate.[80] The main

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[73] 15 U.S.C. § 80b-11 (2013).
[74] *See* Thomson Reuters, 2011 National Venture Capital Association Yearbook at 7 (March 2011) [hereinafter *2011 NVCA Yearbook*].
[75] *Id.* at 7.
[76] National Venture Capital Association, Patient Capital: How Venture Capital Investment Drives Revolutionary Medical Innovation at 3 (2007) [hereinafter *Patient Capital*].
[77] *Id.* at 5.
[78] *See* Thomson Reuters, 2013 National Venture Capital Association Yearbook at 36 (March 2013) [hereinafter *2013 NVCA Yearbook*].
[79] *Id.* at 36.
[80] National Venture Capital Association, Patient Capital 3.0: Confronting the Crisis and Achieving the Promise of Venture-Backed Medical Innovation at 8 (2013) [hereinafter *Patient Capital 3.0*].

reason given by venture capitalists for their decreased funding is the uncertainty of a return on investment.[81] Companies hoping to survive must find new avenues for funding.

One available method of funding is selling securities to the general public through an IPO. There are several reasons why a company may decide to “go public”. First, a company may want to go public in order to raise money and make it easier to raise money in the future.[82] Second, going public improves the ability to sell shares in the company by allowing the general public to purchase shares. This has the additional benefits of setting a defined value for the company and allowing owners and employees to more easily sell shares of the company.[83] Third, an IPO makes acquiring another business easier because you can use shares of a public company to fund the purchase.[84] Fourth, it improves the ability of a company to attract, retain, and compensate employees because it can do so with stock and stock options in a public company.[85] And fifth, an IPO can generate publicity, brand awareness, and prestige for the company, all of which can improve its ability to sell its products or attract potential acquirers in the event that the goal of the company is to sell itself to a larger parent.[86]

The reasons for becoming a public company are very compelling; however, there are several factors that should be taken into account before making the determination to offer or sell securities to the public. First, completing an initial public offering will take time and money and may divert the attention of certain key employees during that time.[87] Second, a public company has significant obligations including: filing SEC reports; and keeping shareholders and the market informed and current on the company’s financial condition, business, operations, and any

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[81] *Id.* at 5
[82] Small Business and the SEC, *supra* note 20.
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*

changes in management.[88] These new, ongoing obligations will require a significant amount of management's time and will increase costs.[89] Third, the company, the board of directors, and the executive management may be liable if the new legal obligations are not met.[90] Fourth, a public company has less flexibility to manage its own affairs, particularly since the company's public shareholders must approve certain actions.[91] Finally, a public company has less privacy since certain information – such as disclosures about material contracts, suppliers, customers, and financial statements – will need to be disclosed to the general public, including competitor companies.[92]

It is clear that the requirements placed on a public company, specifically with regard to disclosures and reporting, are particularly onerous and burdensome. These burdensome requirements may explain why companies wait so long to "go public". These companies do so even though it has been shown that companies experience 90% of their total growth after completing an IPO.[93]

Small high tech medical instrument companies can be very capital intensive yet they may lack the expertise and manpower to submit to the additional regulation of the SEC by going public through an IPO. Going public adds a significant burden to any company but it is an especially important consideration for small high tech medical instrument companies because the CEO of those companies also tends to be a lead innovator, even possibly the founder of the company. Having the attention of a lead innovator and decision maker diverted to filling out quarterly and annual reports could be detrimental to the success of the company. Further, the

[88] Small Business and the SEC, *supra* note 20.
[89] *Id.*
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] 2013 NVCA Yearbook, *supra* note 78, at 8.

public itself is harmed by the regulation because it decreases productivity in an area that can literally save lives.

Complying with the initial registration statement required by SEC under the '33 Act is cumbersome and time consuming.[94] The company must file their initial registration statement, which must include three years of audited financial statements.[95] The auditor must be an independent certified accountant registered with the PCAOB.[96] The company CEO and CFO must certify the financial statements and certain other aspects and they are held civilly and criminally liable for the accuracy of the filings.[97] During this time, the company will generally have the assistance of an investment banker and one or more lawyers. Therefore, although it is a burdensome process, they have the expertise and assistance to get it done and get it done right.

When it comes to the periodic filing, they are on their own. They have all the same requirements as the initial filing, except that they must file them annually and quarterly.[98] They have to know what to file and when to file it. They must continue to submit financial statements audited by an independent certified accountant registered with the PCAOB.[99] Additionally, they have a duty to assess and report on internal controls over financial reporting and have an independent auditor attest to the controls.[100]

Another issue for all innovative companies is that the company cannot be accurately evaluated due to the way that Generally Accepted Accounting Principles ("GAAP") require companies to realize earnings and expenses for research and development. Expenses are deducted at the time they are incurred, but the earnings from discoveries are not realized until

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[94] Small Business and the SEC, *supra* note 20.
[95] *Id.*
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *Id.*
[100] Small Business and the SEC, *supra* note 20.

they are relatively certain to occur. For some companies this can be years after the initial discoveries were made.

Due to the unduly burdensome reporting and disclosure requirements, it is simply not feasible for small life sciences, biotechnology, or medical device companies to raise money through an initial public offering under the current statutory and regulatory environment. The next section will discuss some recent legislation designed to reduce the reporting and disclosure burden on small businesses.

IV. Recent Legislation and Regulations Designed to Reduce the Burden on Small Businesses and Provide Access to Capital

Congress and the SEC have taken a number of steps recently to help smaller companies sell securities directly to the general public without incurring significant reporting and disclosure burdens. Additionally, Congress has understood that there is an increased availability of information available to investors and has opened the primary market up to lay investors. The following sections will discuss the "Smaller Reporting Company" exemption, created by the SEC using its exemptive authority,[101] and "Emerging Growth Company" exemption, created by Congress.[102] These exemptions provide relief from certain aspects of the registration and reporting requirements. The last section in this part will discuss the 2012 Jumpstart Our Business Startups Act ("JOBS Act").

A. "Smaller Reporting Company" Exemption

A company qualifies as a smaller reporting company if it has public shares outstanding of less than $75 million or, in the event that it cannot calculate its public shares outstanding, it has

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[101] 17 C.F.R. § 229.10 (f) (2013).
[102] 15 U.S.C. § 77b(a)(19) (2013).

less than $50 million in annual revenue.[103] A smaller reporting company has a slightly scaled-down version of reporting requirements which includes a less extensive narrative disclosure than other reporting companies, including the description of executive compensation; two years of audited financials, as opposed to three; and no auditor attestation of internal control over financial reporting, as required by the Sarbanes-Oxley Act Section 404(b).[104]

B. "Emerging Growth Company" Exemption

If a company has less than $1 billion in total annual gross revenues in its most recent fiscal year and did not issue any public common equity securities prior to December 8, 2011, it qualifies as an emerging growth company for the first five years after its IPO, unless it breaches certain disqualifying thresholds.[105] An emerging growth company has a slightly scaled-down version of reporting requirements which includes a less extensive narrative disclosure than other reporting companies, including the description of executive compensation; two years of audited financials, as opposed to three years; no auditor attestation of internal control over financial reporting, as required by the Sarbanes-Oxley Act Section 404(b); and an ability to choose not to become subject to certain changes in accounting standards.[106]

C. Jumpstart Our Business Startups Act

The JOBS Act is of Congress' recognition that although disclosure and prevention of fraud are vital to the vibrancy of the capital markets, if start-ups and growing businesses cannot gain access to the capital markets, than the vibrancy of the capital markets does not live up to its potential impact on economic growth. The JOBS Act amended certain provisions of the '33

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[103] 17 C.F.R. § 229.10 (f)(1) (2013).
[104] 17 C.F.R. § 229.10 (f) (2013).
[105] 15 U.S.C. § 77b(a)(19) (2013).
[106] *Id.*

Act[107] and the '34 Act.[108] The JOBS Act also changed the Commission's remit by forcing the it to make certain rule changes such as (1) eliminating the solicitation ban on private placements, (2) increasing the Reg. A exemption to $50 million, and (3) giving them an entirely new directive to promulgate regulations to permit crowdfunding.

1. Eliminate Solicitation Ban on Private Placements

The JOBS Act requires the Commission to eliminate the general solicitation and general advertising ban in Reg. D.[109] This allows companies to solicit investments from potential investors and allows the company to advertise the investment but only if all of the purchasers under the offering are accredited investors and the issuer has taken reasonable steps to ensure that the investors are accredited.[110] The SEC has promulgated Rule 506(c) to implement this requirement.[111]

2. Increase Regulation A Exemption

The JOBS Act requires the Commission to develop new regulations to permit offerings up to $50 million a year without requiring SEC registration.[112] This is similar to the current Reg. A which has a limit of $5 million.[113] An important change from the current Reg. A is that issuers will be required to file annual audited financial statements with the Commission and may be subject to other reporting requirements.[114] The SEC has yet to adopt any final rules to implement this mandate and companies cannot use this exemption until final rules are adopted.[115]

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[107] 15 U.S.C. § 77a *et seq.* (2013).
[108] 15 U.S.C. § 78a *et seq.* (2013).
[109] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 210, 126 Stat. 306 (2012).
[110] *Id.*
[111] 17 C.F.R. § 230.506(c) (2013).
[112] 15 U.S.C. § 77c(b) (2013).
[113] Small Business and the SEC, *supra* note 20.
[114] 15 U.S.C. § 77c(b) (2013).
[115] Small Business and the SEC, *supra* note 20.

3. Crowdfunding

Title III of the JOBS Act, also known as the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 ("CROWDFUND Act"), requires the Commission to develop new regulations to permit raising capital by crowdfunding.[116] Crowdfunding is a means of raising money by collecting small amounts of money from a large group of people.[117] Websites offering crowdfunding have grown tremendously in recent years through companies such as Kiva, Kickstarter, and GoFundMe. To date, these companies only allow the recipients raising money to receive donations or loans without being able to provide a security interest in the company.[118] The CROWDFUND Act requires the SEC to allow companies to raise up to $1 million per 12-month period without requiring SEC registration.[119] Companies will not be able to crowdfund on their own but must go through a registered intermediary.[120]

Individual investors will be limited in the amount they can invest annually through crowdfunding. If the investor has a net worth or annual income of less than $100,000, then they can invest the greater of $2,000 or 5% of their annual income or net worth.[121] If the investor has a net worth or annual income of greater than or equal to $100,000, then they can invest the lesser of $100,000 or 10% of their annual income or net worth.[122]

[116] 15 U.S.C. § 77d(6) (2013).
[117] Small Business and the SEC, *supra* note 20.
[118] *Id.*
[119] 15 U.S.C. § 77d(6) (2013).
[120] *Id.*
[121] *Id.*
[122] *Id.*

The SEC published their proposed rules on October 23, 2013, with comments due back by February 3, 2014.[123] The Commission has yet to adopt any final rules to implement this mandate. Companies cannot use crowdfunding to raise funds until final rules are adopted.[124]

V. PROPOSED SOLUTIONS

There are three possible solutions to ease the reporting and disclosure requirements faced by small high tech medical instrument companies. The first solution is an exemptive relief order issued by the SEC that relieves some of the reporting and disclosure requirements for small innovative companies. The second solution is a potential business model that allows small high tech medical instrument companies to access capital from the general public and in turn allows small retail investors to participate in an investment area with the highest potential for growth. The third solution is proposed SEC rules and regulations for implementing the CROWDFUND Act.

A. Proposed Exemptive Relief Order

Small life sciences, biotechnology, and medical device companies are inherently risky investments that may not be suitable to all investors. Yet these companies offer much more to the investor than just the opportunity to make a profit. They allow the investor to contribute to the advancement of medical or biomedical technology, to invest in people living longer healthier lives, or, if the investor wishes, to eliminate baldness.[125]

In order to increase access to capital markets, the SEC should adopt a new exemption under the ’33 Act for companies whose primary business is innovation or research and development (“R&D”). The SEC is permitted to grant such relief through an exemptive order

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[123] Crowdfunding, 78 Fed. Reg. 66427 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pt. 200, 227, 232, 239, 240 & 249).
[124] Small Business and the SEC, *supra* note 20.
[125] For a patent on disguising baldness see U.S. Patent No. 4,022,227 (filed Dec. 23, 1975).

under their general exemptive authority. These companies should still be required to file a registration statement but with less disclosure. The new disclosure should eliminate the need for the financial statements to be audited by an independent certified accountant registered with the PCAOB and instead simply require that they be audited by an independent certified public accountant.

Additionally, as innovative and R&D companies are more sensitive to human capital, they should be required to disclose the identities of their primary researchers. Because innovation and R&D have long incubation periods and do not go through heavy upswings and downswings, the Commission should eliminate the Form 10-Q quarterly report and change the Form 10-K annual report to a bi-annual report (a Form 10-S, if you will). In order to protect investors in this new landscape, the continuing disclosure obligation should be heightened. This would not add to the burden of a company because continuing disclosures could be as easy as filing a press release with the SEC. Human capital is the major asset in innovation and R&D. It is far more important to disclose that key players joined or left the company than it is to report how much money was expended in R&D.

B. Proposed Business Model to Enable Equal Access to Capital and High Growth Investments

Instead of requiring companies to issue securities to the public, open-end management investment companies, commonly known as a mutual fund, can be a conduit for investing in privately held companies. A sufficiently large investment company will qualify as an accredited investor and can therefore participate in private placements. An investment adviser could be tasked with reviewing a potential company and determining whether or not it is a sound investment. A mutual fund could be set up for each industry and even permit shareholder involvement in selecting valuable targets. With the improvements in communication technology that have been made since the enactment of the Investment Company Act and the Investment Advisers Act, shareholders can be engaged to a much larger degree than ever before. One possible implementation of this is to set up the individual funds such that shareholders can have live access to see the composition and value of the fund.

An open-end management investment company presents two issues that must be addressed. First, the shares must be readily redeemable. Second, all purchases and redemptions must happen at Net Asset Value ("NAV"). The redeemability can be accomplished in one or more ways: maintaining a portion of the fund in liquid securities that are easily sold; maintaining a portion of the shares in cash or cash equivalents; or having access to a credit facility for the purpose of facilitating redemptions. Determining the NAV can be somewhat difficult since there is no readily available market for the securities. This could likely be determined either by last sale or by the initial investment updated for any material changes in the underlying company.

C. Proposed Rules and Regulations for Implementing the CROWDFUND Act

The SEC has not yet promulgated the rules and regulations for the CROWDFUND Act, despite the statutorily imposed deadline for such regulation having passed. For this reason, the SEC has an excellent opportunity to promote a set of regulations that enable companies to access capital markets. Congress seems to be implementing the CROWDFUND Act on a test basis by placing a limit of $1 million on the capital that can be raised. The SEC should promote a regulation that sets this amount at $5 million in order to be consistent with the current Reg. A exemption. The SEC is permitted to grant such relief through an exemptive order under its general exemptive authority.

The limit on individual investment makes a lot of sense. It ensures that no one can lose all of their money if a company is a bad investment. This restriction should be lifted, however, for accredited investors and investment companies under the exemptive authority of the SEC. Additionally, the SEC should promulgate a regulation specifically allowing for the resale of securities purchased through funding portals. The regulation should state that the security is still exempt for resale provided that the resale is also done through the funding portal. This will allow access to the same information the initial purchaser had when they first purchased the security.

The CROWDFUND Act is an extraordinarily powerful tool that finally puts retail investors first. Implementing this Act correctly will actually increase transparency. People are more likely to read a statement on a webpage about the company than they are to read the company's prospectus. It has the capability of reaching more people, getting more people involved, and ultimately will produce better results.

VI. CONCLUSION

Although Congress has taken several steps to enhance access to capital markets for small companies, the measures fall short of what is required to allow equal access for all. The SEC has been slow to implement the reforms that Congress has mandated. It is time for the SEC to fulfill its mandate, not just to protect the investor but to create orderly and efficient capital markets. Instead of erecting barricades, the SEC should be building bridges. It is in the interests of the economy, the capital markets, and the individual investors that the SEC promotes regulations that offer some sort relief to small innovative businesses and allows participation by individuals, rather than just institutions. The regulatory regime that the SEC enforces is outdated and needs a facelift.