Submission

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Re: Proposals for Increasing Economic Growth and Workers' Security

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Proposals

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Introduction

To be optimally responsive to your call for "proposals that will create real economic growth and jobs, and help reverse years of stagnant wages and widening inequality," Commonwealth Group believes that systemic solutions are needed. Only a comprehensive and, just as important, integrated approach can directly impact jobs (including job retention) and wealth generation for average Americans.

Given that small businesses generate half the nations' jobs, are the source of all net new jobs, and are the primary drivers of economic activity in local communities, empowering them to retain and create jobs, pay higher wages and share ownership with their employees would best accomplish the goals of this RFP.

Thus, the five proposal areas presented herein are parts of an integrated whole, designed to produce results directly in line with the goals of this RFP.

We are also providing an additional document that contains extensive background information, analysis and recommendations, and goes into a considerable amount of detail on each proposal. Given the broad scope of these proposals, it will take some time to provide complete proposed legislative language. However, we will provide preliminary examples.

Our solution begins with the introduction of a central entity in the form of a new securities-related SRO (self-regulatory organization) dedicated to the small business community, tasked with overseeing and regulating all the existing capital formation and transfer mechanisms, along with new ones proposed herein.

The next three proposal areas introduce new mechanisms to be added to those already covered by the SRO. Last is a specific tax proposal that gets to the heart of how we can dramatically increase employee ownership and thus begin to reverse widening wealth inequality.

1.

Self-Regulatory Organization (SRO) for Main Street Small Business Securities Regulation

The majority of professions that require extensive training, experience or knowledge are commonly policed by a professional association that sets standards and conducts oversight. Examples are the medical, legal, engineering and real estate professions. Those entities are normally established by professionals from within their industries who set the rules for admission, behavior, monitoring and discipline. They are, in other words, self-regulatory organizations or SROs. The assumption is that no regulator can understand the medical profession better than doctors; likewise, for other professions. Thus, the government largely takes a hands-off approach to those industries.

Yet when it comes to small businesses and their capital formation needs in particular, none of the three entities that regulate small business capital markets came out of or directly represent the small business community. The SEC, FINRA and state securities regulators have time and again demonstrated that they do not understand the small business world. All three of those organizations are an outgrowth of the government's reaction to the stock market crash of 1929, necessitating the establishment of a comprehensive law enforcement approach to capital markets, especially on Wall Street, where malfeasance is widespread enough to demand "cops on the beat." What Wall Street doesn't need much help with (especially in comparison to small businesses) is market facilitation, i.e., raising money and obtaining other resources.

Main Street is another matter. While there is a need for a "sheriff's office" to guard against bad behavior, such behavior is much less common than on Wall Street. Instead, Main Street small businesses are in great need of market facilitation and better access to capital, credit and other support resources.

Thus, we propose the creation of a new SRO for Main Street capital markets, established by the small business community, who best understand their own needs and how to police their members, just like the doctors and real estate brokers. But more importantly, the SRO would better facilitate their role as the country's prime job creators. It would be responsible for all things related to capital markets for small businesses (emerging growth companies [1]and smaller), including the initial sale and resale of securities, brokerage, investment banking, trading markets, the new entities proposed herein and more. It would assume administration of existing laws, rules and regulations until and if it develops replacements.

2.

Federal Benefit Corporations (FBCs)

If we want corporations to treat their employees better, whether on issues of pay, benefits or working conditions, we can go a long way toward those objectives by addressing the underlying legal mandates reflected in corporate charters. When a corporation is formed by filing articles of incorporation with a corporation granting jurisdiction (like each state), the corporation inherits all the rights, privileges, authority and purpose provided for under the statutes of that jurisdiction. The growing desire to have corporations behave in a more socially and environmentally positive manner has

1 *https://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm*

resulted in one of the biggest, most widespread and quickest changes in corporate law in our nation's history - all in a mere six-year period.

In 2010, Maryland became the first of 30 states (including Delaware, plus Washington D.C.) to adopt statutes creating a new type of for-profit corporation. The legally defined goals of these corporations' mandate that they be more responsible and positive in their impact on society, workers, the community and the environment, in addition to making a profit. These new entities, usually called benefit corporations, stand alongside traditional corporations in state statutes as an option for incorporators.

The problem is that there are still 19 states that have not yet authorized benefit corporations, representing approximately one third of the U.S. population, including five of the 10 most populous states – Texas, Ohio, Georgia, North Carolina and Michigan. In those states, founders wishing to establish a benefit corporation must incorporate in another state and then register as a "foreign corporation" in their own state. What is needed is a federal charter alternative for the establishment of benefit corporations, analogous to a federal bank charter established under the OCC (Office of the Comptroller of the Currency, a Treasury Department bureau that charters, regulates and supervises all national banks.) We call benefit corporations established under this proposed federal charter Federal Benefit Corporations (FBCs) and propose to have them authorized under the SRO.

3.

Small Business Holding Companies (SBHCs)

In contrast to Wall Street big businesses, Main Street small businesses often struggle to obtain sufficient capital, credit and other resources needed to launch, grow and fulfill their business objectives. Size and legal status bears heavily on that struggle. Most small businesses are privately held and most big businesses are publicly traded companies. Securities laws (see the SRO above) and other factors make it difficult for individual small businesses to survive and thrive on their own.

The key to the solution lies in the words "on their own." Individual companies lack strength, but grouped together they can more closely resemble a single large company. Done correctly, this mechanism can allow them access to the same resources as big businesses, particularly financial. Investors would spread their risk over the group rather than one company and, with the right legal structure, the group could provide those financial backers with the same freedom to get in and out of their ownership position by selling their ownership interest (shares) on the open market (liquidity).

To accomplish these goals, the small business community needs a new legal vehicle that would partially resemble a mutual fund for small businesses. However, mutual funds are mandated to "passively" invest the majority of their funds in publicly traded securities, and small private companies do not fit that model. Besides, small businesses need much more than passive investments. In addition to capital, they also need increased access to credit and to the kinds of support services provided by business incubators and accelerators. The needs of startups and early stage companies are quite different from those of growth companies, and they in turn are different from mature, steady state companies. Yet all need money and support.

To cover the diversity of small businesses, what's needed is to combine the aggregation of a mutual fund with the best aspects of business development companies (BDCs); commercial credit companies; venture capital, private equity and angel funds; and a public holding company (like Berkshire Hathaway).

We propose a new entity that we call a Small Business Holding Company (SBHC), authorized and formed under the SRO. SBHCs would be capable of doing any and all the functions of the individual entities in the hybrid combination above, including provide early stage angel and venture funds, growth funds, buyout funds, loans and other credit facilitations. Other support can include shared services (accounting, payroll, insurance, etc.), facilitation of cross marketing and more.

SBHCs are intended to be public companies, allowing investors to buy and sell their shares whenever they want. Thus, the SBHC solves the problem of lack of liquidity in private companies. And to maximize the benefit to employees, shareholders and other stakeholders, we propose that they be required to be state or federally charted benefit corporations.

SBHCs can be deployed in all manner of locations and industries. They can serve as a public local holding company serving the needs of a wide spectrum of small businesses within a particular geographic area. They also can target certain types of businesses owners such as minorities, veterans or women, as well as specific industries.

Wherever there is a constituency of small businesses organized around some central theme – geography, ownership or industry, an SBHC can serve their needs.

4.

Venture Exchanges

Since the passage of the 2012 JOBS Act and before, there has been much discussion about the need for a new kind of trading platform that would be a junior version of the national stock exchanges. Advocates say that along with the enhanced ability of companies to raise initial funds via JOBS Act mechanisms, investors need a means to exit from those investments in a manner analogous to the national exchanges.

There are legitimate concerns about such venture exchanges, most related to the early stage nature, small size and limited numbers of shareholders found in many of the potential listing companies. It is true that below a certain size, the dynamics that work for larger public companies breaks down. Small companies are not just miniature versions of large public companies and should not be expected to do what they do.

So, instead of having venture exchanges listing standalone companies as though they were miniature versions of larger public companies, we propose that the exchanges require standalone companies to be of a certain minimum size, maturity and resilience in order to be listed individually.

If a company does not satisfy those requirements, the SBHCs described above could provide a solution. A small business that wants to access public markets for more investment, as well as provide their shareholders with a means to exit from their investment, can link up with an SBHC. If the company is in need of capital, it can apply to the SBHC to obtain an investment or even sell the company for cash from and/or stock in the SBHC.

One of the features of proposed SBHCs would be that investors, whether through private placements by the SBHC or public offerings, would be allowed to define where they want their investment to go, i.e., which company or groups of companies are to receive the bulk of their investments (some funds are retained for SBHC overhead). We call those "directed investments."

Once a small business arranges to be partially or wholly owned by an SBHC, the company's managers can solicit investors, only instead of those investors receiving stock directly in the small company, they receive stock in the public SBHC and the money is directed to the small company. Thus, the company

gets the money it needs but the investors receive public stock. Later, if the small business survives, grows and reaches the point where it can viably stand on its own on the venture exchange (or perhaps a national exchange), it can then arrange to be spun out, go public and be listed independently. If it never reaches that size, it nonetheless may still be able to access public funds and the resources it needs to be a healthy and thriving contributor to the local and national economy.

Therefore, as part of the scope covered by the above SRO, we propose to include venture exchanges that conform to the above restrictions for listing either as a standalone company or under an SBHC that would be the publicly listed company on the venture exchange. And like SBHCs, such venture exchanges can be organized around a geographic focus, an industry or ownership type, or any mix thereof.

5.

Defer Taxes on Employee Stock Grants & Options

To begin reversing the decades-long transfer of wealth to the already wealthy (one of the mandates of the RFP) it's necessary to examine a key fundamental – it normally takes money to make money. To buy stock in the companies they work for or in others, the current system requires employees to have excess cash to invest. Employees, especially those at the lower end of the income scale, barely have enough money to survive, let alone to invest so that they can grow their own nest egg.

Companies could just give stock to employees in the form of stock grants, as a means of providing them a stake in their company. However, a problem with the tax code can actually create more harm than benefit from such stock grants because the IRS treats them as though they are equivalent to cash, regardless of whether the employee can actually translate that stock into cash.

The IRS calls it "constructive receipt" and the recipient of such a stock grant results in an obligation to pay tax on the "theoretical value" of the stock, as of the day of receipt.

If the stock grant is made in illiquid shares in a private company, with no means of converting that stock into actual cash, the IRS does not care and will expect the tax due with the next tax return. Stock options, under certain conditions, can produce a similar taxable event and with similar results to the employee. For example, during the "dot bomb" crash in the early 2000s, many families were literally bankrupted due to the AMT requirements for stock grants/stock options that were underwater or worthless at tax time.

The solution is to change the tax code to redefine the stock grant as a tax deferred transaction rather than a taxable event in itself. That is, no tax is due on the stock received until the employee actually converts the stock into cash or some equivalent value. That way the employee has the resources to pay the tax due when it becomes due, but is not harmed in the meantime. And this stock grant can come from both private companies and public companies.

If the stock is never sold or converted to cash, then the employee would not incur a tax obligation. For example, if a retiring business owner gives half of the business to long-term employees, the new owners have a claim on half of the profits of the business and control of the business, which can go on theoretically forever. If they pay themselves and the previous owner any dividends, those are taxed as normal and any direct profit sharing in the form of salaries, bonuses etc. trigger normal taxes. The IRS still gets income but the employees don't pay tax on the stock itself until and unless the company is sold.

If that same owner were to give those employees the same half ownership and the whole company is then acquired for cash, then the employees would owe tax on their portion of the sales price. If the company is acquired in a tax-deferred stock swap with an SBHC, the employees would receive stock in the SBHC and would only be taxed when they sell some or all of those shares on the open market.

The net result of this change in the tax code could be a massive shift in the building of wealth by employees, even for employees at the low end of the wage scale. Probably no single thing could have as much impact on the problem of inequality as this simple change in the tax code. ■

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