Submission

To: The Staff of the Senate Committee on Banking, Housing and Urban Affairs

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Re: Proposals for Increasing Economic Growth and Workers' Security

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Background Information on Proposals

Introduction

This document provides extensive background information, analysis and recommendations, and goes into considerable detail on each proposal described in outline form in our RFP response. We begin by re-stating some of the elements in that response.

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. However, most efforts to aid small businesses focus on solutions for individual companies. Taking our cue from the natural world, where individual survival is often enhanced in a group, we have approached this with the idea that group solutions for small businesses can be better for all.

Thus, the five proposal areas presented are parts of an integrated whole, designed create a supportive ecosystem that will produce the results solicited in the RFP. 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 past three decades have seen a dramatic erosion of average income for American workers and a massive transfer of wealth to the already wealthy. Much of that can be traced to the relentless drive to suppress wages, the fight against unions, the driving of factories and jobs overseas, stock buy-backs and other mechanisms designed to increase the profits of big business. In spite of that spike in profits, job creation in big businesses has flatlined. They have the money – but they don't create jobs.

Yet jobs for average Americans provide the bulk of the fuel that drives the nation's economy. And the majority of those jobs are actually located in small businesses spread throughout the country. Historically, small – not big – business has been the nation's prime job creation engine. Small and medium sized enterprises (SMEs) with 20 or fewer employees account for almost 50% of all American jobs and nearly a 100% of all new job creation. In other words, Main Street, not Wall Street, is the heart of the American economy.

For this reason, we need to help small businesses create more and better paying jobs, and build more wealth for more people. This aligns with the "ownership society" envisioned by President George W. Bush, who in 2004 noted that, "if you own something, you have a vital stake in the future of our country. The more ownership there is in America, the more vitality there is in America, and the more people have a vital stake in the future of this country."

A lofty goal, one toward which there has been little progress and, if anything, a retreat. While relative unemployment numbers came down under the Obama administration, many jobs pay substantially less than in years past and underemployment remains stubbornly high. The United States needs to create millions of well-paying new jobs and raise the wages of current jobs in order to bring employment and average income numbers up to healthy levels. Yet even in good times, small businesses struggle to launch, grow and create jobs. Raising capital, in the form of both investments and credit, is often at the heart of that struggle.

Unfortunately, capital markets for small businesses, difficult even in normal economic times, are far from optimum. The SME business community has a very limited voice in Congress compared to big business. SMEs are often treated as smaller versions of Wall Street companies (they are anything but) and thus are usually subject to many of the same rules and regulations that work for big business, but for them, are counterproductive.

As a consequence, entities such as the Securities & Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA), tasked with oversight of the capital markets for all businesses (including SMEs), tend to focus their attention and resources on big business and Wall Street. To make matters worse, neither the SEC nor FINRA appears to adequately understand the SME community and certainly are not very responsive to its needs.

Part of the problem is that those entities look at that world primarily through the lens of compliance and enforcement, i.e., their role is to "protect the public." And while bad behavior is widespread on Wall Street, it is much rarer on Main Street. Thus, rather than a "sheriff's department," Main Street needs more of a "community economic development group" approach that facilitates small business capital markets.

The JOBS Act of 2012 was intended to address a number of these shortfalls. It did reform some government regulation that exacerbated the difficulties for small companies, but it can be considered a partial success at best (and slow in coming, especially on the part of the SEC,) since it failed to address many of the most intractable problems faced by SMEs.

Since small businesses are the nation's only real hope for job creation, fundamental changes are necessary in how this community's capital markets are regulated. Theorist and futurist R. Buckminster Fuller supplies the solution: "You never change things by fighting the existing reality. To change something, build a new model that makes the existing model obsolete."

Who best knows what this community needs? The answer, not surprisingly, is the SME community itself. As with doctors, real estate brokers, engineers and other professions, self-regulation by experts in their particular field just makes sense. Their industries do so through organizations that are referred to as self-regulatory organizations (SROs). They set their own rules for admission, behavior, monitoring and discipline. Thus, the AMA regulates doctors, the ABA lawyers, and so on. The SME community is no less an area of specific knowledge and activity, and only members of that community can best nurture and oversee their own domain.

A SME SRO would best be organized and managed primarily by representatives from the SME community, including lawyers, accountants, entrepreneurs, individual investors, private equity funds, venture capital and angel funds, securities broker/dealers, lending institutions, foundations, educational institutions and community economic development entities, as well as representatives from federal, state and local government.

The SRO, which we propose be named the Small Business Regulatory Authority's (SBRA), would be responsible for regulating capital markets for SMEs and ensuring that investors are adequately protected. SMEs shall be defined as public or private companies that are considered "emerging growth companies"[1] or smaller, provided they are not a full SEC reporting company.

The jurisdiction granted the SBRA shall include at a minimum new issues and secondary trades of securities issued by SMEs; brokers, dealers and agents who deal in SME securities; investment companies that invest primarily in SMEs; collective trading systems for SME securities such as ATSs and stock exchanges; and investor protection for all parties. It would also include the new entities described below.

Its authority shall preempt all state securities regulations, and it shall be empowered to establish rules that are enforceable in all states. It shall also be authorized to empower individual states to expand on, and experiment with, their own intrastate securities activities, provided that they do not interfere with the interstate activities under the SBRA's jurisdiction.

With the exception of fraud prosecution, the SBRA would be responsible for taking over all existing rules and regulations promulgated and administered by the SEC and FINRA with respect to SMEs, and it would maintain those rules and regulations until and if it replaces them with its own. Thus, there should be no hiccup in the transition from the old regulations and regulators to the new.

We are therefore calling for the establishment of this new SRO, parallel and equal to FINRA and partially equivalent to the SEC, tasked with regulation and oversight of the capital markets related to SMEs, one that would take over a subset of the activities currently performed by the SEC (excluding fraud

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

oversight) and all of those of FINRA related to Main Street businesses, leaving the SEC and FINRA to regulate Wall Street. This new organization would be built from a broad cross-section of appropriate parties from the small business community, who intimately understand the needs of that community and who can develop the needed solutions.

When Congress established the SEC, it authorized it to designate independent, non-governmental organizations as SROs tasked with performing certain activities on behalf of and under the auspices of the SEC. FINRA is such an SRO.

However, given the SEC's (and FINRA's) lack of understanding of the needs of the SME community, it would be problematic to have either agency attempt to define what this new SRO should be empowered to do and to try to craft their relationship to it. That definition would best come from Congress working in conjunction with representatives from the SME community, resulting in new enabling legislation that would establish the framework, objectives and mandates for this new SRO.

While the SEC has the authority to define and establish such an SRO, doing so would likely take a long time and likely wholly miss the mark due to the SEC's lack of understanding of small business and its needs.

A faster and more effective approach is through a congressional mandate, crafted in conjunction with representatives from the small business community. Commonwealth Group offers to provide the Committee with the appropriate draft legislation, along with the additional elements contained in the below additional proposals for new elements not currently part of the SME ecosystem.

2.

Federal Benefit Corporations (FBCs)

For a number of years, investors and other stakeholders have lobbied for corporations to be more socially and environmentally responsible, including treating their employees as valued assets of the company rather than expenses. That push is gaining traction worldwide, and in the U.S., has resulted in two developments.

First are companies that become certified as B Corporations[2] by a non-profit certification organization called B Lab. That certification reflects a voluntary adoption of business practices that are considered more socially and environmentally responsible than conventional practices. Etsy is one of the first B Corps to go public representing a paradigm shift for a Wall Street listed company.

To be granted and to preserve certification, companies must receive a minimum score on an online assessment for "social and environmental performance" and satisfy the requirement that the company integrate B Lab commitments to stakeholders into company governing documents (by laws and other such instruments).

As of September, 2016 there were over 1,860 "B Corporations" (B Corps) worldwide. The problem is that B Corps lack any statutory protections to back their objectives, so they may be subject to pressures through such things as shareholder lawsuits challenging their voluntary goals.

2. *https://en.wikipedia.org/wiki/B_Corporation_(certification)*

A solution to that problem was presented by Michael Sauvante in his academic white paper *Rewiring Corporate DNA*,[3] published in 2008 with Case Western Reserve University. He pointed out that if society truly wants to change corporate behavior to make corporations more socially and environmentally responsible, tinkering at the edges is not enough. We need to change the underlying statutes that form the legal basis for corporations.

The folks at B Lab were thinking along similar lines, and engaged attorney William Clark to draft model statutes that could be used to craft state legislation defining a new class of for profit corporation.

This became the basis for the second development in the form of a statutorily defined corporation called a benefit corporation[4] that makes such socially and environmentally responsible behavior mandatory and protected.

The goal was to establish statutes that would sit alongside conventional corporate statutes but with four key differences. The new statutes would:

1. Mandate that the corporation pursue a material positive impact on society and the environment.
2. Mandate that directors and officers consider the interests of all of the corporation's stakeholders.
3. Mandate that the corporation provide its shareholders with a periodic published report demonstrating that the company is pursuing that public benefit purpose.
4. Provide a legal "firewall" for the directors and officers that allows them to pursue that public benefit objective without risk of being sued for making decisions and pursuing strategies that might include other than pure financial factors.

The true game changer came in 2010 when, through the efforts of B Lab, Clark and others, Maryland authorized the nation's first benefit corporations. With the adoption of those new statutes, the country now had a government recognized (not just third-party certified) corporation with a purpose that transcends pure profit.

What happened after that is no less than a tsunami of change across the country. Benefit corporations are currently authorized by 30 U.S. states and the District of Columbia (representing around two-thirds of the U.S. population.)[5,6]

Even Delaware, the state with the most public companies registered, is promoting its own form called Public Benefit Corporations. The majority of state legislatures, in both red and blue states, have agreed that corporations need to have a larger purpose than solely making money. Such fast and widespread adoption represents a sea change in support of the public's desire to have corporations be more responsible to society and the planet.

It is important to note that these new benefit corporation statutes offer entrepreneurs an additional option for incorporation. They do not require existing conventional corporations to adopt benefit corporation goals, although they may adopt them if the shareholders vote to convert (usually requires a super majority approval). Nonetheless, it is likely that once benefit corporations become more visible, there will be subtle and overt pressure on conventional corporations to adopt the benefit form of corporate governance.

Such behavior is compulsory if a company is incorporated under such statutes, and management can be compelled to do so by the courts. Conversely,

3. *Rewiring Corporate DNA, BAWB Interactive Working Paper Series 2 (2). pp 9-27, The Fowler Center for Business as an Agent of World Benefit (BAWB), Weatherhead School of Management, Case Western Reserve University. https://commonwealthgroup.net/doc/Rewiring.pdf*

4. *https://en.wikipedia.org/wiki/Benefit_corporation*

5. *https://commonwealthgroup.net/doc/StatesWithBenefitCorporations.pdf*

6. *The first state to adopt such statutes was Maryland in 2010. Since then, over three fifths of states have adopted them, including staunchly conservative states, representing one of the biggest and fastest changes in corporate law in the nation's history.*

management is shielded from shareholder lawsuits for making decisions that are based on those objectives. As of August 2016, more than 3,000 benefit corporations. However, to the best of our knowledge, none have gone public so far.

We anticipate that companies that become benefit corporations will want to tell the world, with the expectation that it will enhance their public image and translate to increased sales and a higher share price. Market forces (i.e., capitalism in its truest form) may very well drive the adoption of this alternative code more effectively than any mandatory action ever could.

Already corporate thought leaders are embracing benefit corporations as the future. Industry heavyweights Sir Richard Branson and Salesforce CEO/Founder Marc Benioff have joined forces to actively promote benefit corporations and Certified B Corporations in a program they call Born B. They describe Born B this way:

"The startup community is a powerful driver of disruptive innovation, creativity and change in the business world. New companies have the opportunity to manage their businesses in progressive and innovative ways from the start, rather than backwards engineering them when they become large and complex. When a new company embraces and integrates social and environmental purpose into its core business model from inception, it has the opportunity to vastly improve its ability to address long-standing global challenges. Companies who do this will realise significant benefits for their investors, shareholders and customers. We call this being 'Born B'."

B Corps and benefit corporations differ from traditional C corporations in purpose, accountability and transparency, but not in taxation. What is significant about both is that, in part, they are required to value their employees and to treat them in ways that are often diametrically opposite of the way Wall Street companies often treat their employees. Paying them a living wage, treating all employees equally and helping them grow and prosper is fundamental to their mandates.

Corporations can be both incorporated as a benefit corporation and obtain certification as a B Corp, and doing so yields the optimum for all stakeholders. However, only benefit corporations have the force of law behind them, and thus if a choice has to be made, benefit corporation status is preferred.

Establishing new companies as benefit corporations or converting existing ones is a quick and easy way to legally and fundamentally change how employees are treated and compensated, without waiting for such things as minimum wage increases mandated by law. Unfortunately, 19 states have yet to adopt such statutes, representing nearly one-third of all Americans. And five of those are in the top 10 most densely populated states.[7] Companies within those states would have to incorporate in another state under current conditions and operate in their home state as a "foreign corporation."

Which leads to the objective of this particular proposal. In order to provide all American workers and business owners with the opportunity to be covered by benefit corporation statutes, we propose that the aforementioned SRO be authorized to establish "federal benefit corporations" or FBCs.[8] Where a state has already adopted benefit corporation statutes, its residents can choose to either incorporate in that state or under the federal FBC statutes, in a fashion analogous to state versus federally chartered banks. States lacking benefit corporation statutes would still have the federal FBC option.

And as noted, to date we are unaware of any benefit corporations that have gone public. But when

7. *Texas #2, Ohio #7, Georgia #8, North Carolina #9 & Michigan #10*

8 *See http://benefitcorp.net/attorneys/model-legislation for the model statutes adopted by most states*

they do, they will introduce issues that may create complications for the market and for regulators. That's because the thrust of existing regulations, especially around reporting by public companies, is largely focused on "disclosure" that for the most part could be characterized as the company showing that they are not doing anything illegal.

In contrast, the reporting required of B Corporations and with many of the state benefit corporation statutes, flips that around. One could characterize them as requiring the company to prove that they are "doing good" and show the world how they are doing that, i.e. abiding by their mandate to be more socially and environmentally responsible, in addition to good financial stewardship. The current markets are not really designed to provide that kind of disclosure. But if we want to fundamentally change corporate behavior, our public companies need to make this shift as well.

With that in mind, we propose that these new federal benefit corporate regulations provide for the type of disclosure and reporting that best reflects this alternative way of doing business. This may be difficult to adapt in the near term to public markets on the national exchanges, but can be made a fundamental part of the venture exchanges described below.

And finally, the following SBHC proposal mandates that a corporation be a benefit corporation, and thus having this FBC option guarantees that SBHCs can be established anywhere in the country and satisfy that requirement.

3. Small Business Holding Companies (SBHCs)

In the introduction, we addressed the idea of group efforts to help small businesses. That concept is at the heart of the following new business entity. It builds on the idea that by bringing many small businesses under the umbrella of a single organization (a holding company)[9], they can achieve much greater strength and capabilities than they can possibly achieve individually. The single stick that can be easily broken versus a bundle of sticks that is much harder to break is an apt analogy.

In addition, this entity will solve the omnipresent problem of illiquidity[10] for small business investors by virtue of the holding company being public. Investors invest in the public holding company and it in turn invests in the small companies.

Note: The basic concept of how individual companies can benefit by joining forces under a common holding company, is explored in depth in these two videos - Video on SBHC origins by Michael Sauvante and Strategic Aggregation by Gordon Bizar

To understand this concept, let's start by analyzing capital markets. Capital markets for businesses in the U.S. can be divided into two broad categories, based on the liquidity of the investment.[11] In general, public companies[12] are quite liquid, if the company is large enough and listed on a trading platform like a stock exchange. Individual investors can generally get in and out of their investment in a public company at any time. Raising capital for such companies is relatively easy.

In contrast, most SMEs are highly illiquid. And that translates into a much more difficult capital formation environment. Raising money for small businesses is notoriously difficult, in large part because individual investors generally cannot get in and out when they want, and often the entire firm has to be sold in order for the investors to pull their money out. And selling an individual firm can often take months, a year or more - if ever.

9. https://en.wikipedia.org/wiki/Holding_company
10. http://www.investopedia.com/terms/i/illiquid.asp
11 http://www.investopedia.com/terms/l/liquidity.asp & https://en.wikipedia.org/wiki/Market_liquidity
12 https://commonwealthcapital.net/business-valuations/public-or-private/

Yet, if we are to find a way to enhance investment in SMEs for the benefit of the country and all stakeholders, we need to find a way to overcome the illiquid nature of investing in SMEs and ideally provide their backers with the same liquidity enjoyed by public company investors.

Fortunately, we have a model that we can draw upon, one that has been in existence since 1980 although it has rarely been used as originally intended. It's a special type of investment company called a "Business Development Company."[13] BDCs came out of the venture capital (VC) industry where the original promoters saw them as a way to use a public company to fund typical VC investments in small companies – a "public venture capital company" as it were, wherein the investors can be anyone, not just wealthy investors.

Investors rich and otherwise could invest in the BDC, a public company, and the BDC would invest in small, private and illiquid businesses. Thus, small businesses would receive funding, but the investors would not be constrained when exiting their investment, being able to buy and sell their shares on the open market just as with any other public company.

Unfortunately, the BDC industry has drifted far from its original intent and today concentrates primarily on making loans to middle market companies (much bigger than the majority of Main Street small businesses.) As a result of regulators' shift in emphasis to accommodate that, BDCs are no longer viable as a means of capital formation for the bulk of SMEs. Nonetheless, the core BDC architecture can serve as a model for a new entity that would fulfill the original objective – and more.

Thus, we are calling for the creation of a new corporate entity to be formed under the above SRO. We call this new entity a Small Business Holding Company. SBHCs would be a special type of public holding company created to facilitate the financing and support of small businesses. They are intended to be public companies and, somewhat like a mutual fund, can serve as a collective investment vehicle to invest in other companies.

However, while mutual funds have to invest at least 85% of their assets in publicly traded securities (stocks and bonds by companies listed on the stock market), an SBHC would invest in, own and lend to a large number of small, private (not public) businesses. Think of them as a public venture capital company, private equity fund, mutual fund and commercial lender rolled into one entity for small businesses. This allows the average person, not just wealthy investors, to invest in something that resembles a VC or P/E fund, but do so in a fashion more similar to a mutual fund. Public SBHC investors would be able to freely sell their shares, just as with any other public company.

And one of the key benefits to all stakeholders is that by combining numerous small companies under one corporate umbrella, the whole group will realize a higher value than the sum of their individual valuations. This will occur even if the holding company is a private company.[14] We explore this concept in depth in this analysis paper Business Valuations.[15]

If the holding company goes public, then normally the value of the whole enterprise would go up even higher. We explore this concept later in that paper, as well as on our Commonwealth Capital website here[16] and here.[17]

This collective valuation jump occurs by aggregating a number of smaller companies and then taking the whole group public. No changes in the actual business of each of the individual companies need take

13 https://en.wikipedia.org/wiki/Business_Development_Company

14 https://commonwealthcapital.net/business-valuations/public-or-private/

15 https://www.commonwealthgroup.net/doc/BusinessValuations.pdf

16 https://commonwealthcapital.net/business-valuations/

17 https://commonwealthcapital.net/business-valuations/valuation-and-liquidity/

place for the whole group to become more valuable than could be realized by just the sum of the value of the individual companies. However, total valuation could go up even further if each of the individual companies under the SBHC were made healthier and more profitable. Here's how that would be done.

In addition to providing financial assistance, SBHC would be required to take an active role in the oversight, support and management of their portfolio companies. SMEs not only lack access to financial resources, but they also often lack access to expertise and resources that could have a dramatic and positive impact on their health and vitality. A high percentage of small business owners have succeeded in building and running their company more through shear persistence than through a broad understanding of business itself.

Many try to reinvent wheels that were invented long ago, and many do not know how to take advantage of recent developments like social marketing. How much healthier and more profitable they could become if that expertise were available to them.

That's why we liken an SBHC to a large, virtual business incubator/accelerator[18] that, in addition to capital (and credit), provides a wide spectrum of support services to its investees, including helping them with shared services, cross marketing assistance and more. It is not out of the question that each portfolio company could realize substantial individual growth (with possible new jobs being created in the process) as a result of this access that they lacked prior to becoming an SBHC subsidiary.

Of course, capital is not the only financing needed by SMEs. Credit is equally if not more important. But where does that credit normally come from?

According to a 2012 FDIC community banking study,[19] "By carrying out the traditional banking functions of lending and deposit gathering on a local scale, community banks[20] foster economic growth and help to ensure that the financial resources of the local community are put to work on its behalf."

FDIC defines community banks around criteria related to traditional lending and deposit gathering activities and limited geographic scope. They generally have less than $1 billion in assets. And even though community banks have historically been the primary source of credit to local businesses (the area of greatest need), today they are under severe strain to stay afloat themselves.

According to the FDIC study, their numbers have declined precipitously since 1984. More than 10,000 banks (~60% of all banks) have gone out of business or been absorbed by a bigger bank, often because they, like other small businesses, need better access to capital! And that trend has greatly accelerated since 2008, especially for the smaller, more community centric banks. The decline in the number of banks with assets less than $100 million accounted for all of the net decline in total banking charters. The number of banks with assets less than $25 million declined by 96%!

The demise of community banks cuts off a critical source of new money for local economies. As of 2012, community banks held 21% of banking industry assets, but 54% of small loans to farms and businesses. If local banks disappear, big banks are not an alternative. Wall Street banks (historically reluctant lenders to small and medium-sized enterprises) have drastically cut small business lending. Today they devote only 18% of their commercial loan portfolios to small business, and their approval rate for small business loans is below 10%.

All of which leads to the following additional recommendations with respect to SBHCs. First, like BDCs, SBHCs should also be allowed to lend to SMEs (as a non-bank lender) in addition to investing in them. Like BDCs, SBHCs should be allowed to borrow an

18 https://en.wikipedia.org/wiki/Business_incubator

19 https://www.fdic.gov/regulations/resources/cbi/study.html

20 https://en.wikipedia.org/wiki/Community_bank amount up to and equal to their total assets under management (AUM) and ideally the 200% currently being sought from Congress by the BDC industry.

Next, SBHCs should also be allowed to invest in and/or own community banks and other financial institutions without being considered a bank holding or financial holding company subject to supervision by the Federal Reserve (unless the majority of the SBHC's AUM is in banks and financial institutions, fitting the definition of the kinds of companies held by FED-regulated "financial holding companies.") As SBHCs are all about providing money and other support to small businesses, investing in local community banks would be consistent with that mandate.

By direct lending and through ownership in community banks, SBHCs can provide credit facilitation via their bank(s) to a wide variety of small businesses within a community, with the likely exception of startups. Community banks rarely lend to companies less than two years old. However, loan guarantees by the SBHC could change that, so that even early stage companies could receive loans from the banks that are part of an SBHC ecosystem. Add to that the BDC-like characteristic of SBHCs that we advocate and the SBHCs could be direct lenders as well.

That addresses credit, but what about capital? What types of companies would benefit from investment by SBHCs?

A comparison with VCs is useful here. Whereas VCs normally focus on earlier stage companies, an SBHC would be capable of supporting small businesses throughout their entire life cycle, from startups to growth companies to mature companies. There is a general misconception that startups and growth companies are the only small businesses worth investing in. Existing businesses, whether growing or not, are a vital component of our nation's wealth, and wealth preservation is just as important as wealth growth. Today, this latter category is in jeopardy.

Our nation is currently at risk of losing a substantial portion of its wealth in the form of mature small businesses. It turns out that approximately 60% of all existing small businesses are currently owned by baby boomers who are beginning to retire en masse. Unfortunately, there are insufficient conventional buyers to absorb the anticipated number of businesses that will be put up for sale and there is no systemic solution on the horizon.[21]

That is until we consider SBHCs. SBHCs can be used by communities to purchase local businesses from retiring owners (rather than looking for individual buyers) and keep them as productive assets. In essence, the community becomes the buyer. This concept represents the only systemic solution for dealing with the rapidly unfolding problem of boomer-owned business closures.

And because an SBHC's investors already have "anytime liquidity", no small business under an SBHC need ever be sold in order for profits to be extracted for investors. An SBHC can easily have a permanent "buy and hold" business model.

In contrast, VCs, angel funds and similar private investment groups invest in companies that will grow in value and then go public for a higher value or be bought out. Their business model only works if they can "buy low and sell high." Thus, they are usually only interested in startups and growth companies, not mature, stable firms.

Not so with an SBHC, which can realize benefit out of small businesses regardless of their age and growth. If they are likely to continue as a viable, productive business, an SBHC can be an investor. Thus, with the likely exception of small businesses without employees, businesses (including those with no employees) can benefit from its direct lending (or indirect through its bank(s)). There is no other single type of support entity in existence today that can rival the broad support that SBHCs can provide the

21 *https://www.linkedin.com/pulse/retiring-business-owners-flood-market-michael-sauvante*

SME community and the wide spectrum of stakeholders they can serve.

As we previously noted, small businesses are the backbone of local economies in the United States and around the world. They create more jobs than all other sectors combined (big business, government, non-profit, etc.) and yet often struggle to survive due to lack of capital, expertise and other resources that are commonly available to large businesses. SBHCs are designed to solve that problem by bringing the resources available to public companies down to local small businesses. By providing those resources to small businesses, SBHCs help them to survive, grow, create more jobs and in general better serve their communities. Thus, SBHCs inherently provide a broad public benefit by their very existence, an objective of this RFP.

An SBHC can go further by incorporating the concepts of sustainability and triple bottom line, i.e., ensuring the whole enterprise is not only financially successful, but socially and environmentally as well.

That brings us back to B Corporations and benefit corporations, which represent a natural constituency for an SBHC that wishes to incorporate sustainability. An SBHC that fully embraces sustainability will be helping to not only foster small businesses in general, but will be moving them as a group towards a more inclusive form of capitalism that will better serve all stakeholders – employees, managers, owners, customers, suppliers, the community in general and society as a whole.

The best way to accomplish that is to require that an SBHC be formed as a state or federally chartered benefit corporation. This will ensure that they are obligated to do all that they can to optimally serve all stakeholders.

As part of that requirement, the enabling legislation for SBHCs should also provide for representation at the governing board and advisory board levels, along with the kind of real time reporting they will need to make available online at all times. In addition, the SRO (SBRA) will need to review their initial charter application for full compliance with these and other requirements before they are granted full SBHC status.

If the organizers of the SBHC satisfy those initial and ongoing reporting and information requirements, then SBRA will grant them the ability to make public offerings in the form of an IPO and follow on public offerings, wherein the shares sold would be freely resalable without restriction in a manner that is equivalent to fully registered shares under the current regulatory environment. No further "registration" statements would be required after the initial one, provided that the ongoing published information remains available. Rather, the SBHC would simply provide a notification to SBRA that it is making another public offering and the general details about the offering such as size, number of shares, etc.

In addition, once the initial application has been approved, the SBHC would be allowed to make an unlimited number of private placements wherein the securities sold in that manner would automatically become freely tradable after a six-month holding period. Keep in mind that as a benefit corporation, the SBHC already has a higher ethical mandate than required of existing stock markets and their listing companies, and can even be taken to court for not fulfilling that mandate. Therefore, the disclosures and subsequent actions on the part of the SBHC should rival or exceed even the best behavior and investor protections that can be found on Wall Street.

With respect to both public offerings and private placements, the SBHC would provide a means by which investors can instruct the SBHC as to how their investment is deployed. In this way, the investor can inform the SBHC if they would like to see the bulk of their funds be directed to a particular group of companies or even one particular company. We call this a "directed investment."

The SBHC would be under no obligation to invest those funds where the investor requested. But to the extent that it intends to make an investment in that group of companies or the individual company, while reserving whatever is required to fund its other activities, the SBHC will attempt to follow investors' wishes.

What this means is that an individual small business that becomes a partially or wholly owned subsidiary of the SBHC may go their supporters (customers, investors, family, friends, etc.) and ask them to invest in the SBHC with a directive that the funds so invested should be, to the extent possible, placed with that particular small business. Any shares received by those investors would become freely tradable shares after six months (per the above) and therefore the individual small businesses can encourage their supporters to invest knowing they will have publicly tradable stock after a short holding period.

Later, if the small business reaches the point where it can viably stand on its own on, it can be spun out as a public company in its own right. That may be on a national exchange or on the below described venture exchanges where it can then arrange to be listed independently. If it never reaches that size, it nonetheless may still be able to access public funds and other resources via the SBHC, allowing it to continue as a healthy and thriving contributor to the local and national economy.

4.

Venture Exchanges

The JOBS Act in 2012 was the first major new legislation in many decades designed to enhance the means by which small businesses can raise capital, and do so by making general solicitations to different segments of the public. The emphasis here is that the money so invested goes into the small business and those investors now have a stake in the ownership of those companies.

Prior to the JOBS Act, the initial sale of equity into such small companies was usually done on a very limited basis, through private transactions with a limited number of investors. No broad advertising of the sale of stock was allowed. Now small companies can sell stock in a more open fashion, much like larger public companies.

But even though small companies under the JOBS Act can more freely sell their shares to the public, the re-sale of those holdings has not been made any easier. So, if we are to continue with the opening of markets for capital formation for small businesses, we need to address the needs of the investors as well as the small companies. After all, few investors are interested in investing in a company but never wanting to get their money back.

What is the solution? 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.[22,23] It is true that below a certain size, the dynamics that work for larger public companies breaks down. Small companies are not just

22 NASAA Testimony on "Venture Exchanges and Small-Cap Companies" before the Subcommittee on Securities, Insurance and Investment of the Committee on Banking, Housing, and Urban Affairs, March 10, 2015 http://www.nasaa.org/34863/venture-exchanges-and-small-cap-companies/

23 SEC Testimony on "Venture Exchanges and Small-Cap Companies" before the Subcommittee on Securities, Insurance and Investment of the Committee on Banking, Housing, and Urban Affairs, March 10, 2015 https://www.sec.gov/news/testimony/testimony-venture-exchanges.html miniature versions of large public companies and should not be expected to do what they do.

So, instead of having venture exchanges that purport to be miniature versions of national exchanges, with listed companies that are treated as miniature versions of larger public companies, we propose that venture exchanges be formed with a recognition that standalone companies have to be of a certain size, maturity and resilience in order to be listed individually. This white paper[24] by University of Utah law professor Jeff Schwartz proposes those same requirements.

For example, we would propose that a company be at least two years old, be profitable and show indicators that it will likely continue to be profitable. Companies that have lasted at least two years and are profitable have a much higher probability of survival than younger, non-profitable companies.

Companies that are at least two years old but are not cash flow positive would not qualify because they still have a high chance of failure. That lack of positive cash flow can occur because the company is growing very fast and its financial needs outrun its income and therefore it needs capital and credit in order to maintain that growth. Such fast growing companies are still very risky.

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 to sell the company for cash and/or stock in the SBHC. An SBHC can bring them in under its structure and provide it with capital and credit as needed, especially if it is in a high growth phase and needs access to financial resources and other help. Such an investment, if properly managed, could prove to be very beneficial to both company receiving the investment and the SBHC and its shareholders.

There is also a unique feature of SBHCs that will help them to specifically fund such companies. 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 that kind of investment "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 of the above SRO, we propose to include venture exchanges that conform to the above restrictions for listing standalone companies or those under an SBHC, which 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 focus or ownership type (such as minority, veteran or women-owned businesses) or any mix thereof.

24 Venture Exchange Regulation: Listing Standards, Market Microstructure, and Investor Protection https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2836725

5.

Defer Taxes on Employee Stock Grants & Options

All of the above focuses on small businesses themselves and how they can be made healthier, which in turn allows them to generate new jobs and protect the jobs they already provide. But aside from improving the quality of those jobs and the treatment of the employees, including higher and more equal wages, what they don't address directly is how to increase employee ownership in order to address inequality, one of the mandates of the RFP.

Congress has recognized this problem and passed a very recent bill in the House of Representatives, *H.R.1343 Encouraging Employee Ownership Act of 2017*[25] that calls for some changes in SEC rules pertaining to issuers being able to more freely sell stock to their employees.

While laudable in its intent, there is one key problem with efforts like these — who can take advantage of the opportunity. Given that it requires that the employee have sufficient free cash so as to be able to buy the stock being offered by the company, this benefit is in practice restricted to only those employees at the higher end of the wage scale.

Those at the bottom, representing the employees at the worst end of the inequality divide, are the least able to take advantage of it. So, while higher paid employees can get a piece of the action, not all employees can.

This is one of the main reasons that employees do not have a bigger stake in the nation's wealth. The key fundamental is that it normally takes money to make money. To buy stock in the companies they work for or in any others, the current system requires them 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.

Can anything be done about that? Well, companies could just give stock to employees in the form of stock grants, as a means of providing them a stake in the company. However, that presents a problem that could cause more harm to the employee than good. It has to do with the tax code concerning such stock grants. The IRS treats these grants as though they are equivalent to cash, whether the employee can actually translate that stock into cash or not.

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.

Under certain conditions, stock options can produce the same taxable event and with similar results to the employee. For example, during the "dot bomb" crash in the early 2000s, many a family was bankrupted due to the alternative minimum tax (AMT) requirements for employee stock grants/stock options that subsequently became underwater or worthless come tax time.

The solution is to change the tax code to redefine the stock grant as a "tax deferred" transaction rather than a tax triggering event in itself. That is, no tax is due on the stock received until the employee actually converts that stock into cash or some equivalent value. That way the employee has the resources (cash from the stock sale) 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. We would propose the only group excluded from this provision be C level officers in public companies, as they already have a range of options that allow them to obtain ownership in their companies that are not normally made available to other employees.

25 https://www.congress.gov/bill/115th-congress/house-bill/1343

So what happens if the stock is never sold or converted to cash? In that case the employee would not incur a tax obligation. It would mean that the employee has an ownership stake in the company, but ownership does not itself produce any direct tangible financial benefit to that employee that should trigger a taxable event.

Such a taxable event would only occur through:

- A "dividend," something already covered separately in the tax code and for which tax would be owed by the dividend recipient,
- Profit sharing based on ownership – again something already covered in the code separately, or
- The company is sold, at which point the employee stockholder would share in the proceeds and owe tax on their portion of the gain.

Example:

A retiring business owner gives half of the business to long-term employees, who now have a claim on half of the profits of the business and control of the business. If they pay themselves and the previous owner any dividends, those are taxed as normal dividends to shareholders. And any direct profit sharing in the form of salaries, bonuses etc. would likewise trigger normal taxes, so the IRS still gets income from those transactions. The employees just don't pay tax on the stock itself unless the company is sold.

If the owner were to give those employees the same half ownership and the company is then acquired for cash, the employees would owe tax on the portion of the sale they receive as owners. If the company is acquired in a tax-deferred stock swap with another company like an SBHC, the employees would receive stock in that company and would only be taxed when they sell some or all of those shares to a subsequent buyer.

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.

Finally, should this proposal be enacted into law, there is one existing provision of the tax code that could be coupled with this new one to further enhance the benefits to employees, especially those working for small, Main Street businesses with a limited number of existing owners. It concerns the taxes associated with gifts.

In general, someone can receive a gift having an identifiable value up to a certain amount per year, without triggering a taxable event to either the donor or the recipient. In 2016 the maximum amount was $14,000 per year. Here's how that could work to enhance the benefits to employees proposed above.

Let's return to the example of the owner who is willing to give half of a small business to the employees. That owner could give $14,000 worth of equity in the business to each employee without triggering any tax to either party. What's more, if the owner is a husband and wife team, they each can donate $14,000 worth of their holdings to each employee (must be carefully documented as separate gifts). That means that each employee would actually receive $28,000 maximum per year – tax free! Any additional owners could gift each employee up to $14,000 worth of equity per year.

Anything above that amount would be subject to the proposal contained herein, where the amount above the maximum gift amounts would be treated as a tax-deferred event until the equity is later sold by the employee. If they sold the equity received as a gift, they would be liable for taxes only on any gains over the original amount received, which would likely be subject to ordinary income or long-term capital gains, depending on how long the employee held onto the equity before selling it.

The net result of combining the new legislation with the existing gift rules could mean that employees could realize a significant jump in their personal wealth. For a minimum wage employee, a combined husband and wife gift of $28,000 worth of equity could represent a good deal more than a years' worth of wages, with no tax due on that gift. Anything above that can be held with no further tax problems till it is sold.

We would recommend that an informational campaign be launched nationwide encouraging small business owners to gift ownership and provide stock grants to their employees to allow them to share in the wealth they had a hand in helping to create. This could be especially significant to baby boomer small business owners who would like to retire and yet help their employees share in that transition. ■

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