THE SECs ROLE IN CAPITAL FORMATION: HELP OR HINDRANCE?

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BEFORE THE

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OVERSIGHT AND INVESTIGATIONS

OF THE

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THE SEC'S ROLE IN CAPITAL FORMATION: HELP OR HINDRANCE?

TUESDAY, JUNE 26, 2001

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 9:35 a.m., in room 2128, Rayburn House Office Building, Hon. Sue W. Kelly, [chairwoman of the subcommittee], presiding.

Present: Chairwoman Kelly; Representatives Cantor, Tiberi, Gutierrez, Inslee, Moore, S. Jones of Ohio, and Shows.

Chairwoman KELLY. This hearing of the Subcommittee on Oversight and Investigations will come to order. Without objection, all Members' opening statements will be made part of the record.

This morning, we are holding this subcommittee's first hearings on the issue of capital formation. Capital formation has been an implicit responsibility of the Securities and Exchange Commission since it was first created. In 1996, securities laws were amended by the National Securities Market Improvement Act to explicitly state that capital formation is an important responsibility of the Securities and Exchange Commission. In 1995, in testimony before the former Subcommittee on Finance and Hazardous Materials, former Securities and Exchange Commission Chairman Arthur Levitt stated, and I quote: "Existing law already requires the agency to give consideration to efficiency, competition and capital formation concerns whenever the Commission is required to make a public interest determination."

Securities markets are the critical force behind our Nation's economy. It has been one of my long-standing goals in Congress to eliminate obstacles to capital formation in those markets, especially for small businesses.

I am greatly distressed by the concerns that fundamental regulatory obstacles are inhibiting the flow of capital to and investor participation in the small and middle market business sector. This hearing is the subcommittee's first step in determining how we in Congress and the Commission can effectively eliminate those obstacles for all participants in our Nation's capital markets.

Capital is the life blood of business, and efficient access to capital is a crucial ingredient to a strong, growing economy. We have the responsibility to closely examine the different structures the Securities and Exchange Commission has crafted for businesses to access the markets and to determine if these are practical and effective.

Businesses should be able to devote their energies toward their customers and not be delayed by unnecessary requirements that no longer reflect the realities of our new economy. In the Securities and Exchange Commission's work to ensure investor protection and efficient capital formation, I believe the best service they can provide is to ensure transparency in disclosures and ensure fair play through their enforcement division.

A September 2000 General Accounting Office report found that the estimated average total cost needed to conduct a small business IPO during 1994 to 1999 was about 10 percent of the total offering proceeds, while the average total cost for a large business IPO was about 8 percent. The Securities and Exchange Commission has a few different processes for smaller businesses and smaller offerings which were designed to reduce the regulatory burden for these issuers. We will examine the effectiveness of some of these processes here today.

In addition, in 1996, the Securities and Exchange Commission was given general exemptive authority to allow them to waive specific requirements on a case-by-case basis in order to give the Securities and Exchange Commission additional flexibility in assisting businesses' access to the capital markets. I intend for this subcommittee to take a close look at how that authority is being used.

Before us today, we are honored to have a distinguished panel of witnesses to share their thoughts and observations with us on these issues. I thank all of you for taking the time out of your busy schedules to spend some time discussing these issues with us today, and I would let Members of the subcommittee and staff know that it is my intention to enforce the 5-minute rule, and I would appreciate their cooperation in this.

I am now going to recognize my friend from Chicago, Mr. Gutierrez, distinguished Ranking Member for this subcommittee, for his opening statement.

Mr. Gutierrez.

[The prepared statement of Hon. Sue W. Kelly can be found on page 28 in the appendix.]

Mr. GUTIERREZ. Well, good morning, Chairwoman Kelly, and thank you for holding this hearing. I would like to welcome all of the panelists who have come here today to share their views on the important issue of capital formation.

The mission of the U.S. Securities and Exchange Commission is to protect investors and promote efficient capital formation. Challenges facing the Commission in accomplishing its mission are no different today than the challenges that existed in 1933 when the U.S. Federal Government first began regulating the issuance of securities. The premise of the 1933 Act is that full and fair disclosure would most effectively promote efficient and fair functioning in the process of capital formation.

We are here today to study and discuss possible changes to the existing regulatory structure to facilitate capital formation for small businesses and all market participants. Small businesses are an important source of economic growth and creation; they account for 50 percent of the gross domestic product and the majority of new jobs.

Access to capital is a critical issue for small businesses. Without sufficient capital, small businesses are unable to develop new products and services or grow to meet new demands. Insufficient liquidity is frequently cited as a cause of small business failure. Small firms are heavily dependent on bank float, trade credit and informal sources of financing such as personal savings, credit cards, home equity loans and loans from family and friends.

Steps have been taken by both the Federal securities regulators and State governments in an attempt to reduce some of the regulatory burden and costs for small businesses seeking equity capital financing in the regulated securities market. One of the steps taken by the Federal securities regulators has been simplifying Federal registration of securities offerings and exempting certain small businesses' securities offerings from several requirements, Regulation D, in an attempt to reduce the regulatory burden and the cost for small businesses in equity capital formation.

One of these exceptions, Rule 504 under Regulation D, is intended to allow companies to raise seed capital. A company may privately sell up to $1 million in securities in a 12-month period to any investor without registration as long as there is no public solicitation or advertising or resale of the share; and resale of the share is restricted. A company may sell the same amount of securities using public solicitation if it has registered the securities in a State that requires: one, public filing of a registration statement with the State and; two, the delivery of disclosure documents to investors.

From 1992 to 1999, the Securities and Exchange Commission dropped the State registration requirement from Rule 504. They then experienced a substantial increase in the number of complaints they received from investors who have been defrauded by operations selling shares under Rule 504. The Securities and Exchange Commission found that fraudulent operations had developed that would go to States that had no substantive registration requirements and sell securities to residents in those States. This resulted in substantial incidence of fraudulent sales to the general public of securities for which no information was publicly available.

Another step taken by the Securities and Exchange Commission to minimize the regulatory costs of raising equity capital has been permitting small businesses' issuers to use simplified, small business forms, so-called SB-1 and SB-2, in filing registration. Small business issuers are those with less than $25 million in revenue in the last fiscal year and outstanding stock of $25 million or less. Even though these forms save an issuer up to approximately $125,000 an average offering, small business issues are viewed unfavorably by many investment bankers because they are too small in size to be profitable. Also, small offerings are commonly distributed by small investment banks that lack the market recognition which can be an impediment to attracting investors.

These problems show that even though many positive steps have been taken to help small businesses gain access to equity capital, more needs to be done. By passing the capital promotion tools in the National Securities Market Improvement Act in 1996, we sought to enhance the Commission's role in promoting capital formation and efficiency with the appropriate investor protections. It is crucial then that the Securities and Exchange Commission balance the burden placed on small businesses against the purposes of investor protections under the securities law.

I look forward to hearing all of the testimonies and thank you, Madam Chairwoman, once again.

[The prepared statement of Hon. Luis V. Gutierrez can be found on page 32 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Gutierrez.

Mr. Cantor, have you an opening statement?

Mr. CANTOR. No, Madam Chairwoman.

Chairwoman KELLY. Mr. Tiberi.

Mr. TIBERI. No.

Chairwoman KELLY. Thank you.

Well, then, if there are no more opening statements, we will begin with our first panel. Before us today we have Ms. Joan M. Sweeney, the Managing Director and Chief Operating Officer for Allied Capital. Before her work with Allied Capital, Ms. Sweeney was an accountant with the Securities and Exchange Commission's Enforcement Division.

Next, we have Gregory Halpern, the Chairman and CEO for Circle Group Internet Incorporated. In 1998, Mr. Halpern distinguished Circle Group Internet by raising $2.5 million as the first and only company to orchestrate a complete end-to-end Regulation A offering over the internet without the assistance of outside brokerage.

In addition, we have Mr. Donald J. Devine, the Vice Chairman of the American Conservative Union, who is the former Director of the U.S. Office of Personnel Management, Grewcock Professor of American Values at Bellevue University, a *Washington Times* columnist, a writer, and an Adjunct Scholar at the Heritage Foundation. And if you don't mind, Mr. Devine, we are all enjoying this column of yours that appeared in the newspaper today. And I am going to, with your permission, sir, and the permission of the subcommittee, I am going to include this in the record. If anybody hasn't read this, you should get the *Washington Times*, take a look at it.

Mr. DEVINE. Well, thank you.

Chairwoman KELLY. If you don't have enough time today, at least this clarifies your position, along with a very good cartoon.

[The article referred to can be found on page 29 in the appendix.]

Finally, we have Mr. James A. Steinkirchner, the Co-Chairman of the National Small Public Company Leadership Council. Mr. Steinkirchner is listed as an NSAD trader since 1996 and is currently the Vice President of McGinn, Smith & Company of Atlanta, Georgia.

We thank you all for joining us here today to share your thoughts on these issues. Without objection, your written statements will be made part of the record, and you will each be recognized now for a 5-minute summary of your testimony, and I would like to begin with you, Ms. Sweeney.

STATEMENT OF JOAN M. SWEENEY, CHIEF OPERATING OFFICER, ALLIED CAPITAL CORPORATION

Ms. SWEENEY. Thank you, Madam Chairwoman. Members of the subcommittee, my name is Joan Sweeney, and I am the Chief Operating Officer of Allied Capital, a public business development company. Today, I am pleased to share our thoughts about improvements to the Federal securities regulatory framework as it impacts capital formation.

Allied Capital has invested in growing businesses for over 40 years. We operate the oldest SBIC license and we have financed thousands of small businesses. We provide mezzanine debt and equity capital, and our portfolio today is just shy of $2 billion.

We constantly see challenges faced by companies seeking capital. As a business development company, we are a successful conduit for bringing public investment dollars to small businesses, but we too are burdened with a cumbersome regulatory regime. I was a member of the Securities and Exchange Commission's Division of Enforcement, and I fully support the Securities and Exchange Commission's role as "cop on the street." However, the authority and activities of the Securities and Exchange Commission staff need a fresh look if the goal is to encourage capital formation as well.

There are three areas I would like to discuss related to improving capital access. First, it is time to embrace the internet. Financial markets are moving at the speed of light and financial information is only a click away. The fact that the Securities and Exchange Commission does not consider information to be publicly disclosed when it is presented on a company's website seems out of touch with the realities of the millennium. This is especially true when online disclosure is required through EDGAR filings. We need to think outside the box and outside the four corners of the prospectus to come to a virtual prospectus that incorporates a company's website.

Second, the Securities and Exchange Commission needs to challenge low value-add activity. Under a 70-year-old system, too much of the Securities and Exchange Commission's activity centers around the review of registration statements. This is cumbersome and low value-added. The law is the law, and the registrant and their lawyers and the registrant's underwriters and their lawyers all know the law, are responsible for it and are liable with respect to compliance with the law. Why, then, is a 30-day review period, often undertaken by an unseasoned examiner, necessary? Legal fees mount, often in response to questions raised only from a lack of experience. More seriously, the delay of this process can result in a missed market window.

The reality is, public offerings are not sold off registration statements. Plain English improves disclosure, but prospectuses are still not read. The majority of public securities are sold to mutual funds, and fund managers research far beyond the registration statement, ironically, using the registrant's website and the internet. To further the irony, individual investors use websites and internet chat boards to get the real plain-English scoop. Why not focus staff time on regulating information in channels that investors really use, rather than allocating limited resources to the review of outdated registration forms?

Third, there needs to be more staff time allocated to exemptive orders and new rulemaking. There are many inefficiencies in the system that could be readily fixed if the staff had the time and authority.

For instance, you may not be familiar with BDCs, such as Allied Capital, and our role in capital formation. BDCs were created by Congress 20 years ago to encourage the flow of public capital to small, private companies. Yet today, the BDC industry is still barely visible. I believe this is largely because operating within the cumbersome yoke of the 1940 Act discourages new entrants.

For example, efficient access to the public markets through integrated disclosure is not available to BDCs. Unlike other public companies, we cannot use our Forms 10-K and 10-Q to update our shelf registration statements. This situation is time consuming and costly and, we believe, results from a mere oversight in the law that could be easily remedied.

We submitted a letter to the staff in July of 1998 to address our integrated disclosure issue by requesting a no-action position. After 3 years of waiting for their answer, last week we were told that under the current regulatory framework, the staff could not grant the relief we were seeking. Instead, we were told to pursue rulemaking, with no guarantee of immediate attention. We essentially waited 3 years to learn we must pursue a different bureaucratic process. This is clearly inefficient.

The staff needs to allocate its resources to foster capital formation through interpretive positions, exemptive orders and rulemaking. I am certain that if they had the time and authority to act, we would not have waited 3 years to find ourselves back at square one.

I believe the changes that I have suggested would improve capital formation as well as enhance investor protection.

Thank you.

[The prepared statement of Joan M. Sweeney can be found on page 40 in the appendix.]

Chairwoman KELLY. I thank you very much Ms. Sweeney. I really appreciated reading your testimony last night as well. So we will get into that more.

Now we move on to Mr. Halpern.

STATEMENT OF GREGORY HALPERN, CHAIRMAN AND CEO, CIRCLE GROUP INTERNET, INC.

Mr. HALPERN. Madam Chairwoman, Members of the subcommittee, thank you for inviting me to this hearing. I am Greg Halpern, founder and CEO of Circle Group Internet. We are a funding and consulting source for emerging technology companies, based in Mundelein, Illinois.

Now, I represent 21 million small business professionals who create half the jobs in America who are not here today, because today is a work day and for them, every day is a work day. My written testimony is going to address most of my issues in detail, but let me summarize.

Small businesses like ours produce more than half of America's private gross domestic product. As you know, by 2005, we will create 60 percent of the new jobs in this country, and these figures are provided by the United States Government so they are not rhetoric, they are reality.

Small businesses struggle to succeed despite often unreasonable and misguided regulations, taxes and very little representation. We face regulations that make raising capital difficult, if not impossible. At today's hearing our concern is with the Securities and Exchange Commission.

Now, the Great Depression, as we know, created the need for the Securities and Exchange Commission, and it has served its purpose. Nearly a century later, however, the Securities and Exchange Commission has failed to keep pace as markets and the global economy have evolved. Now, I am not here to propose increased limitations on the Securities and Exchange Commission's power. Let's help the Securities and Exchange Commission continue its mission and at the same time assist small business.

Today, the process to register with the Securities and Exchange Commission is so time consuming, expensive and subjective that many small businesses either drop out during registration or avoid it altogether. The Securities and Exchange Commission regularly fails to comply with the Act of the Congress, which we have talked about, known as the National Securities Market Improvement Act of 1996, which concerns competition, efficiency and capital formation in the Securities and Exchange Commission's rulemaking activities.

Hundreds of companies retired from the Securities and Exchange Commission's registration process in 2000. The opportunities missed by just these companies represented billions and billions of dollars that could have gone toward jobs, the economy and tax dollars to the Treasury. Was the next Home Depot, Dell, or Yahoo among them? We will never know.

Small businesses register their securities under Regulation SB. The SB, as you know, stands for "small business," and it is supposed to mean a much simpler and friendlier way to enter the capital market based on objective criteria. In reality, though, SB often predisposes the staff against the very companies it is supposed to be serving.

The Securities and Exchange Commission often mistakenly loses sight of its simple, objective mission, which is to ensure full disclosure and then send the companies off to market. Instead, many companies are drained needlessly of time, money and resources, answering endless rounds of questions and waiting for the slow process to resolve itself.

Another issue that affects many small businesses is the Investment Act of 1940, which requires public companies to hold no more than 40 percent of their value in securities of other companies. This hurts firms like ours, because as we fund other emerging companies and their securities increase in value, we find ourselves out of compliance. This means we are becoming victims of our own success.

At the end of the day, this is not about the 1940 Act or Regulation SB, though; it is quite simply about the larger issues of the

Securities and Exchange Commission's role in capital formation. The Securities and Exchange Commission was told in the last century to support capital formation, and it really needs to learn how to work with small businesses in this new century.

Small businesses need relief now. The processes are actually in place; the Securities and Exchange Commission just needs to let them work.

Additionally, I am proposing the creation of a department in the Securities and Exchange Commission to be known as the Small Business Advocacy and Liaison Office. This office should serve small business ventures that require special assistance in reaching the capital markets. It would fall under the Division of Corporate Finance and represent the nineteenth office in the Commission.

The office would advise small businesses how to meet the regulations and requirements of the Securities and Exchange Commission. It would monitor processing of applications and provide quick, reasonable responses. The office would establish a schedule to better prepare businesses for their Securities and Exchange Commission experience, and it would also respond with clear and concise information regarding any difficulties or irregularities with its constituent applicant companies.

And finally, the Small Business Advocacy and Liaison Office would provide an annual review of the Securities and Exchange Commission rules and regulations related to all small business entities and make recommendations to Congress for changes in those policies that may unfairly encumber small businesses.

I thank you, Madam Chairwoman and the rest of the subcommittee, for the opportunity to take a day off and come to Washington to discuss the concerns of 21 million of my fellow small business professionals. I know there is a genuine willingness on your part to help and together we can solve these problems and get on with the task of building our businesses, and the Nation as well.

Thank you.

[The prepared statement of Gregory Halpern can be found on page 52 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Halpern.

I am very sorry, having read your testimony, that your company has had such a problem in dealing with simple things like phone calls not even being returned by any kind of a Federal Government agency.

Now, we turn to you, Mr. Devine.

STATEMENT OF HON. DONALD J. DEVINE, VICE CHAIRMAN, AMERICAN CONSERVATIVE UNION

Mr. DEVINE. Thank you very much, and I would like to thank you very much for holding this hearing.

I think it is a critical question as to whether the agencies and the bureaucracy—and I used to be the chief bureaucrat for 4 years as Director of the Office of Personnel Management—that they actually follow the law. This subcommittee and its predecessor have gone through an enormous amount of activity to try to get the Securities and Exchange Commission to follow the law.

I think when the former Chairman and Mr. Oxley wrote the Securities and Exchange Commission and got its reply, the reply clearly showed that the Securities and Exchange Commission did not understand what it was supposed to do under the law—in order to take into account its other obligations, other than fighting fraud, which is certainly a very important obligation. But that is not the only obligation under the very law under which they operate.

I think we saw this very clearly when they amended Rule 504, under which small companies secured small amounts of capital. It was a critical element in their raising capital. Effectively, the Securities and Exchange Commission took public companies out of the regulated market so that they could raise small amounts of capital with limited bureaucratic review. In my opinion, it is a sad situation, a public scandal really, that this critical legal avenue is not open to small business anymore.

Several tables are in the formal testimony, but I have a larger version here. You see what happened when the Securities and Exchange Commission adopted Rule 504. The market went up and up and up, for years in fact. This is, in fact, the plot from one of these automatic computer programs for it. I didn't fit it in that line.

Now other things were happening. There were tax cuts and things. I am not saying it is the only thing, but clearly that is what happened after those initial Rule 504 reforms.

Now we see in a second chart what happened after the Securities and Exchange Commission made the 1999 change. And this one really amazed me when I looked at it, and again, the computer fitted the lines. It is almost as if there is a perfect correlation. As a former Professor at the University of Maryland and now at Bellevue University, I know this doesn't happen very often. I was just bowled over by it.

But the fact of the matter is that when the Securities and Exchange Commission rule went into effect on April 7th, 1999, the market dropped. It was unstable during the whole period of the OTC registration process. When the OTC registration process ended, it dropped again enormously; and, at the same time, the regular market kept going up. I had that on there too, but it is too confusing to add it.

I have all of the details in my formal testimony here. But, to me, that is the proof. The Securities and Exchange Commission is supposed to pay attention to capital formation. I think their former response to this subcommittee shows they do not.

As I tried to outline in detail in my testimony, the Rule 504 process did not find them taking capital formation into consideration. The only specific amount they mentioned was a $30,000 registration fee, which is a very small part of costs. I estimate that cost alone is about 10 percent, or $250,000, of an offering of about a million dollars. I presented some GAO figures for higher offerings in my formal testimony.

So I just can't say how pleased I am that the subcommittee is looking into this, that they are going to presumably question the Securities and Exchange Commission and ask them why they aren't following the law. I recommend that you also apply consideration of capital formation to their rule for oversight of private exchanges, that the Securities and Exchange Commission try to find a new way for public companies to use Rule 504 or a different rule. It doesn't matter what rule it is, but some way to raise capital.

Also, I would encourage giving more control to stockholders. They are the ones that really can keep fraud from happening.

And that is my time. Thanks for having me.

[The prepared statement of Hon. Donald J. Devine can be found on page 55 in the appendix.]

Chairwoman KELLY. Thank you very much, Donald Devine. We appreciate very much hearing from you.

Next we have some more testimony that I read last night from Mr. Steinkirchner. Mr. Steinkirchner, thank you so much for your testimony; and thank you for appearing here today. Please proceed.

STATEMENT OF JAMES A. STEINKIRCHNER, CO-CHAIRMAN, NATIONAL SMALL PUBLIC COMPANY LEADERSHIP COUNCIL

Mr. STEINKIRCHNER. I would like to thank Madam Chairwoman Kelly and Ranking Member Gutierrez and other Members of the subcommittee for the opportunity to testify on critical issues facing small business.

I am testifying today as the Co-Chairman of the National Small Public Company Leadership Council and on behalf of the small business marketplace we represent.

The Leadership Council, based in Washington, DC., seeks to educate and inform Members of Congress about the economic contributions of small emerging growth companies. Although the Government has made great strides in the right direction, the Leadership Council believes that more cost-benefit analysis needs to be conducted on how it affects small business before laws and regulations are passed.

In my written testimony, I address 10 key issues affecting small business. Today, I will address four.

In 1982, Mr. Devine covered the Rule 504-C exemption. In 1999, the Government amended Rule 504 to a point where nobody would really want to use it. Also, the Securities and Exchange Commission and the press have created a stigma relating Rule 504 to fraud. I doubt very seriously if it ever will be used again in its current form.

Instead, my proposal would be to create a new Rule 509 offering. It is kind of like a quasi-public offering. It would be available to both public and private companies, be able to raise up to $10 million.

Some key points to address. Investor protections, I would mandate that an NASD underwriter would have to be used in this type of offering, can advertise the offering, can use only line road shows, use the modernization that Ms. Sweeney addressed earlier in her testimony.

Abuses of the current short sale rules are depriving individual investors of essential investor protections. They also are making it more expensive for companies to raise capital.

Some possible solutions to the illegal short-selling abuses are: apply the uptick rule to both the NASDAQ small cap and the bulletin board issues; develop a mechanism for tracking short sales; identify 5 percent or more holders of the outstanding stock or 10 percent of the public float; and create a new Rule 13S which would be filed with the Securities and Exchange Commission. Those that have beneficial ownership must currently use a 13D if they earn over 5 percent. Why not make those holding substantial short positions report also?

Some other issues I would like to address are: one, minimum stock price listing requirements for some of the exchanges. When a company stock price approaches or drops below minimum listing requirements, it actually fosters fraud and unethical practices by imposing an artificial guideline in a free market mechanism. A company's management has limited options to keep itself from being delisted. It could create artificial demand by issuing press releases, hiring promoters or reverse splitting its stock. All these efforts are usually offset or exceeded by the short sellers.

Another problem that we have in our industry right now is what is called a "toxic convertible" or a "death spiral convertible." These instruments have exploded over the last 5 years from $274 million to $3.2 billion last year. Private Investment in Public Equity, or another name it is called, PIPE, deals have become a major source of capital for public companies. PIPE deals do have their place in the markets, but it is their offspring, the "toxic convertible," that needs to be regulated. In simple terms, the "toxic convertible" is a private placement that enables investors to convert their securities at a discount to the current market price usually with no floor as to how low the conversion can go.

An investor who buys common stock of an issuer in a toxic convertible loses, on average, 34 percent of his investment 1 year after a toxic convertible is issued. In the year 2000, there were 220 toxic convertibles done, and only five were at a higher price than before the offering. It is obvious the common stock investor is getting burned by these convertibles.

Thank you. I would like to go into a little more. I guess I ran out of time. I would like to thank the Leadership Council and thank you.

Chairwoman KELLY. We thank you, Mr. Steinkirchner. You have a little more time because we will ask you questions.

[The prepared statement of James A. Steinkirchner can be found on page 69 in the appendix.]

Chairwoman KELLY. I would like to begin the questioning by asking all of you one general question, and I want a very succinct answer, please, because I, too, have a time limit.

My question is, I want to know how you think that we can use, or you can use, the internet more effectively to get information there to the Securities and Exchange Commission and to make the disclosures. You have all mentioned the internet. There is a reason that I am sure you want to do that. So, very quickly, if you could all just chime in here. Thank you.

Ms. SWEENEY. I guess I will start.

I think the thing that we see, we invest in companies every day, so we are an investor ourselves, is that you can use a company's website to do everything a registration statement does and in a much more plain English, dynamic disclosure means. So why not set out what are the disclosure requirements that the Securities and Exchange Commission and the law requires and ask companies to comply with them by keeping that information updated on a quarterly basis right on their own website?

I don't know if you have pulled down information from EDGAR recently, but EDGAR is a very, very cumbersome system. There are a lot of private sector systems like 10-K Wizard, and other things that do a lot of things better than does EDGAR, but companies on their own website are really the best at telling their own story. So I think you use the website as the virtual prospectus.

Chairwoman KELLY. Thank you, Ms. Sweeney.

As you were talking about that, you brought up the issue of registration. I just want to quickly ask you one question about that. Since you worked over there, is the registration process used by the staff to leverage extract concessions from a registrant like on a related or an unrelated matter? Is that part of what is happening with the registration process?

Ms. SWEENEY. I don't think so. I think what it just simply is, is cumbersome. I brought, just so you could see, Allied Capital's registration statement. This is our Form N-2, OK? No one reads this. It is impossible. Look at the depth of the print. I mean, what individual shareholder is going to pore through this? They are not going to.

What is the problem in the registration statement process, is that it is an outdated medium of communication. Plain English, didn't really do anything. It made it so you could maybe read it, but still there are tables in here that defy the average shareholder to understand. I mean, it doesn't make any sense. So I think that is the real problem. I don't think necessarily that even the staff understands what is required in a registration statement.

Chairwoman KELLY. Thank you. I want to go on and ask my first question on down, but thank you very much.

I have more questions, but we have been called to a vote. I am going to finish my questions, then I am going to take a break, and with the subcommittee's indulgence we will be back here—can I give everybody just 10 minutes to come back, or do you want a standard 15? We will be back in 10 minutes, but please answer the question.

Mr. HALPERN. The current question?

Chairwoman KELLY. The first question.

Mr. HALPERN. Sure. Certainly, I would second everything Ms. Sweeney said, and I would add a couple of fundamental things.

As you had said, we had the distinction of doing the first end-to-end stock offering on the internet, and I actually thought that it was quite a novel approach, we worked closely with the staff of the Securities and Exchange Commission to clear it and we thought it could be an outstanding model for companies to use in the future.

What we did was, we had the risk disclosure shown first; and it was a simple two pages of risk disclosure that the user could read. After that, they were forwarded on to the downloading of the prospectus; and, finally, if they passed through that, they could see the marketing material and then subscribe online. It was done quite efficiently, in a matter of a week's time we raiseed several million dollars. I thought it would be a great opportunity for small businesses to have access to capital markets.

But the other caveat that I would put in there, which camps on to what was just said, is that if people were to read the registration statements cover to cover and really understand it, they probably wouldn't invest in anything. So that is the reality of it. I think that the idea of full disclosure is an important one, because it basically says, if we have junk, we are telling you we have junk, and you can make a decision if you like junk and you want to invest in it. But, beyond that, the process becomes entirely subjective. Because if somebody doesn't like any aspect of the business, then it becomes a subjective process, and that can go on for some extended period of time.

Chairwoman KELLY. Thank you.

Mr. Devine.

Mr. DEVINE. Well, these people in Government deal much more in this on a practical level. In my experience in the Government, it is very hard for the bureaucracy to do anything new to keep up. That is why, in general, the fewer regulations the better. And certainly it just makes fundamental sense to bring the Securities and Exchange Commission into the 21st century here and use the internet. It is just so elemental, common sense.

Chairwoman KELLY. Mr. Steinkirchner.

Mr. STEINKIRCHNER. The Securities and Exchange Commission has already issued quite a few no-action letters; and Mr. Halpern, I believe, received one relating to the internet. The problem here is it has taken so much time to get the Securities and Exchange Commission no-action letters, and basically what they do is they test the waters with these Securities and Exchange Commission no-action letters. This started way back in 1995, and we are already in the year 2001, and we still don't have a general ruling on internet road shows, things of this nature, offering prospectuses online, signature requirements online. You could go on and on.

I believe right now that in the public arena you will find that probably 90-something percent have a website right now. So it is not like people don't have access to these companies.

I think you could get the private market to embrace the internet also by providing financials, and Mr. Devine says I would like to see them get into the 21st century.

Chairwoman KELLY. Good. That is wonderful. Thank you very much for answering and being, all of you, all four of you, being very clear about it.

We are going to take a break so that everyone can go to the floor and vote, and we will see you back here in 10 minutes.

[Recess.]

Chairwoman KELLY. Mr. Gutierrez.

Mr. GUTIERREZ. Thank you very much.

Professor Devine, the dramatic growth of the internet has provided a new medium for fraudulent operators to reach a much larger audience than was ever possible over the telephone. Mr. Devine, you obviously disagree with the approach that the Securities and Exchange Commission has taken to prevent fraud and ensure that adequate public information is available to investors about small business insurers of securities. What would you do to protect investors from fraud in these markets?

Mr. DEVINE. Well, it is not so much me that thinks that. It was Congress in 1996 that passed the law saying that beside taking into account questions of fraud, that the Securities and Exchange

Commission should also consider efficiency, competition, and capital effects. And that is what I think they need to do to make a balanced judgment, as the law requires them to do. I am not sure that the internet does, in fact, open things up to more people than the telephone. I would suspect more people have a telephone than have a computer or are hooked up to the internet. So, I don't think it's a question of broader opportunities for fraud. I think, in their rulemaking, as opposed to their enforcement action, they need to take into account these other activities.

The Securities and Exchange Commission has had—and they haven't asked for any major changes in the fraud statutes and regulations themselves—they have sufficient powers to pursue fraud. So I don't think it is a question of neglecting fraud. When it happens, they should go after it and prosecute it, and they do and they should continue to do that. I just think it is a question in their rulemaking. They should consider these other important things, and not so much because I say it—although I happen to agree with it—but it also happens to be the law.

Mr. GUTIERREZ. Mr. Halpern, if you could just follow up on what Mr. Devine just said and answer the question. And also, your company has successfully raised capital over the internet in 1998, but dropped out of the registration process in the year 2000. Could you tell us a bit more about how you were successful in 1998 and why you dropped out in the year 2000 and what has changed and maybe talk a little bit concerning the question I raised with Mr. Devine?

Mr. HALPERN. Yes, sir. Well, to follow on to what Mr. Devine, I think, put well, there are many good rules already to protect investors. Yet many investors still lose most, if not all their investments. I mean, we legalize gambling, for example, and let people go lose all of their money. And in essence, you know, investing in the market is a form of legalized gambling. But again, there are many good rules to protect the investors. What I am calling for in that score is if we want to protect investors, then let's protect all investors, including those who have already invested in small business. You see, there is this space in small business where a lot of people don't want to invest because it is risky. And most of these newer businesses, these emerging businesses get their humble beginning from anywhere from credit card financing to their friends and family to get started. Well, after that it is hard for a lot of investors to want to participate, because they don't see where the liquidity is going to come from.

One of the ways, a tremendous stimulation to the economy, is to give investors a greater degree of confidence in these emerging companies, which is—our acronym is advanced small business. It is a business which is growing much faster than businesses used to. In other words, in 3 to 5 years the company is going to hit $100 million. It couldn't do that, you know, 10 years ago. It could only hope a much smaller fraction of that. So I am saying let's protect all investors.

In my case, I already had almost 500 investors in the Regulation A offer I conducted successfully online, and I thought—I think you might have just stepped out when I started to say that I thought that was a very novel process. I was very proud of fact that we had done it online because it worked so well. And I thought, wouldn't this be novel in a lot of small businesses that have a difficult time in getting access to the capital markets. And with Rule 504 and all the OTC things that you hear that are so negative, wouldn't it be great if they had a novel process the way Ms. Sweeney said, to use the internet to produce commerce and investment capital in their business at a minimal amount of effort and a minimal amount of cost. We could essentially create a lot more opportunity for our society. But, you know if we will give investors the confidence to invest in early stages that they are going to achieve liquidity, I believe we are going to dramatically stimulate the economy, and I think new investment capital in that space is sadly lacking.

So the other thing I wanted to say about any negativity about protecting the investor, there are a lot of investor protections. But we must remember that while we can't legislate risk out of existence, we can legislate the future of small business out of existence. And in my own process, all that really happened, Congressman Gutierrez, was that when we did the Reg A we said this is very novel. And by that time the Securities and Exchange Commission was looking at a lot of companies raising money online and saying "this is making us nervous." We didn't see that it would really work. And so when we went back in the process with another self-underwriting, which was the SB2, the small business regulation, I firmly believe, although again I don't blame anybody. I feel that it would almost be a relief for the Securities and Exchange Commission if it had an easier way to cope with small emerging businesses. I don't believe they have a way to cope with it. So they have to move you from point A to point B until someone else says, well, you release it. Well, no I don't want to. You do it. And I think that is a huge problem.

Mr. GUTIERREZ. Well, following up on that, I would like Ms. Joan Sweeney to wrap up, because I am over my time. We have an Executive Summary of "Modernizing the Regulation of Business Development Companies." I would like to ask that this be entered into the record of this hearing and ask Ms. Sweeney when she thinks the report will be done.

[The information can be found on page 34 in the appendix.]

Chairwoman KELLY. Without objection.

Mr. GUTIERREZ. And give us just a brief overview of the report and when you think it will be done.

Ms. SWEENEY. Sure. We, Allied Capital, are a member of something we call the Committee for Modernization of BDC Regulation. And there are a handful of BDCs out there who also share our views that it is just very difficult to operate within the 1940 Act. I don't know how much time any of you have spent with the 1940 Act, but it is a very cumbersome piece of legislation. The subcommittee is now circulating a report within the committee to make sure that everyone agrees that these are the issues, things that need to be done, very, very simple things to modernize BDC regulation. I touched on one in my testimony, which is integrated disclosure.

I mean, that is somewhat of a no-brainer when you get down to it. That is just simply allowing us to do what other companies can do on their Form S-3 registration statement. The other things that we are looking to do is, for instance, break down some of the barriers with respect to affiliated transactions.

The Investment Company Act of 1940 is set up to prevent bad external managers from doing bad things to shareholders of mutual funds. That is a noble purpose and there are bad fund managers. For instance, if you know, the management company is external; it could have cross purposes with the fund. A business development company is usually internally managed. There is no way the business development company is going to disadvantage itself dealing with itself. It is the same entity.

And there is a whole cadre of rules within Section 57 of the Investment Company Act of 1940 that is set up to essentially prevent an activity that really wouldn't happen in any operating company. So there are various things like that that are really simple fixes to the operation that we think could encourage the flow of public company capital to small businesses.

You know, the hardest thing about investing in a small business—Mr. Halpern touched on it—isn't even necessarily the risk, it is the liquidity. You are a company with a market cap of less than $100 million. People will not invest in you simply because you are illiquid. You know getting in and getting out of the stock can cause problems. BDC has fixed that. If you look at Allied Capital, we are about a $2.2 billion market cap BDC. We have huge liquidity. People can invest in Allied Capital, get a nice 8 percent dividend because we pass our earnings to our shareholders. Come in and out of us, while we put money into illiquid companies. Our portfolio to date is about 125 companies that have gotten their investment capital from public investors, but in a liquid format. So we think BDCs are a great thing that should be really studied and embraced.

Mr. GUTIERREZ. Thank you. Thank you very much.

Chairwoman KELLY. We turn now to Mr. Shows.

Mr. SHOWS. No.

Chairwoman KELLY. No questions?

Mr. SHOWS. No.

Chairwoman KELLY. All right. Since there seems to be a bit more to be discussed here I think we will go into—with the indulgence of the panel—a second round of questioning, if that is all right.

Ms. Sweeney, you had mentioned a couple of things that I—one thing in particular I would like to ask you about. I would like to know how the regulatory process can be used to impose unduly burdensome requirements on a company. Can you give us some examples of that?

Ms. SWEENEY. Sure. You know, I think, as I say, there are some pretty simple things and probably the most burdensome process any public company can undertake, whether it is in the initial public offering or in registering securities a second time, third time, fourth time around, is the registration process. That is probably where the average public company touches the Securities and Exchange Commission most frequently. That process is so antiquated and outdated, and it causes huge delays. This is where you will get questions on whether we should be using the word "such" items versus "certain" items. OK, that is a comment. To spend the legal time addressing that comment adds little value, if any, to the registration process.

I don't know if any of you have spent an all-nighter at a financial printer with an army of lawyers responding to a litany of staff questions, largely in plain English. But I can tell you it adds a lot of cost and burden to the process.

The other thing is, I don't think necessarily the level of examiner you get within the Division of Corporation Finance, or other divisions within the Securities and Exchange Commission, really have the business savvy to understand the magnitude of some of their information requests. For instance, we took a company private in the fourth quarter of 2000. This was a company that really couldn't access the public markets, unloved, low market cap. It is our job as a BDC to fund these companies. We took it private and we had to do it through a merger. We actually issued Allied Capital stock to complete the transaction, a very innovative way of using a BDC capital to do something good for another public company. In that process we were floored to find out that, because it was a merger in form and a going private transaction, that there was a requirement in the rules that we had to actually file and disclose board presentations that were done to effect the merger. We are talking about a company's trade secrets, the internal works of the board of directors, as they evaluated why the merger was good, taking their projections and filing it with the public. Now, that is kind of stepping over the bounds of disclosing trade secrets that most likely really wasn't necessary for those shareholders to make an educated decision on the proxy that they were being presented to decide, whether or not they were getting an adequate premium over their market price. There is fairness opinions done by the investment banks. Shareholders can make their own decisions. Shareholders can call management. Understand this: There is no need to take the inner workings, you know, that is pretty confidential information of the board of directors, and file it. So those are the types of things that are just huge, time consumers and also maybe overreaching in terms of disclosure through kind of a registration process.

Chairwoman KELLY. I thank you very much, Ms. Sweeney. One other question that I had was the question about the shelf registration. You mentioned in your testimony that there is a question in my mind about the fact that you can't use information that is already provided to the public through the different forms, the 10-Ks and the 10-Qs. Could you speak about that just a little bit, please?

Ms. SWEENEY. Yes. This is what we think is pretty much an oversight for BDCs. BDCs are required to file 1940 Act forms. So we re-file our registration statement on a Form N-2 every time we post new quarterly information. So, once a quarter we have to update this thing, and fully, all the way through, and refile it and subject ourselves to staff review, once a quarter. If we were Coca-Cola, any other company out there, public company, that doesn't file under the 1940 Act, that files their shelf on something called an S-3, which most companies file, they don't have to do that. They put their S-3 up at the Securities and Exchange Commission and they are allowed to have integrated disclosure. Form 10-Qs and Form 10-Ks update their shelf registration statements. So we have a kind of mechanism that doesn't work, where companies that file on N Forms aren't allowed to do that. Companies that file on S Forms are. A very simple fix would allow those on N Forms to do the same thing.

So this is the thing we have been waiting on for about 3 years to try to solve.

Chairwoman KELLY. Well, good. I am glad we at least had a chance to discuss it. Thank you.

Mr. Steinkirchner, I wanted to just quickly ask you one question, and if you would just fill me in on your thoughts and the new Rule 509 legislation that you had proposed. Could you, sir, please pull the microphone closer to your mouth so we can all hear you? Thanks.

Mr. STEINKIRCHNER. OK. Rule 509 is actually a rebirth of Rule 504 almost. But it adds some more investor protections in there. And basically what I wanted to do with Rule 509 is create a modernization type instrument where you could use online road shows, put your financials up on the site, offer a prospectus all online, because using the internet is cost effective. I mean, it is just much less costly to use the internet. So the Securities and Exchange Commission has allowed it in certain circumstances and it has all worked out relatively well. They haven't revoked anybody's Securities and Exchange Commission no-action letter, so I would say that the online no-action letters that have been approved to date have been working quite effectively.

But I also wanted to create a new investor class that could get involved in private offerings. Currently, the Securities and Exchange Commission segregates investors into two classes, non-accredited and accredited, and what I wanted to do is create a semi-accredited. It is an investor class that is in between these two. Last year, there were five million Americans that qualified as credited investors. Out of that five million, 250,000 contributed about $60 billion to the private marketplace to fund small businesses. And if we could create a new investor class that has the financial sophistication—I mean, I deal with these people on a day-to-day basis. They want to get involved in these private transactions, but are restricted under these requirements. And by adding a layer of protection by making sure that an NASD member underwriter is the only type of underwriter that can underwrite this type of security, what you are doing is you are effective putting the investor under all the NASD scrutiny that both the broker dealers and the issuers have to deal with. So I am kind of covering the investor protection rule there and making sure that the client is suitable for the investment.

Some other issues are I would like to put a cap on it of $10 million, but I also wanted to have a minimum contingency of $2 million, and that the money had to be escrowed in an escrow account. Although this is a little more costly, I think it will protect the investor a lot more. More importantly, by putting a minimum contingency, this will ensure, hopefully, in a lot of cases, that there is enough money for the business to progress.

And I could go over numerous other examples, but the bottom line, Rule 509 is kind of like a quasi-public offering. What you have right now is you have public offerings that are doing private offerings, which are called pipe deals, and we are talking hundreds of billions of dollars have been done in these pipe deals. It is a quick, effective way for public companies to raise money. And now, by using the internet, you have private companies offering over the internet. So effectively they are becoming public offerings. So instead of having two separate classes, why don't we just put it right in the middle? In a way, it is like a quasi-public/private offering. But it would open it up to another 12.8 million Americans, would afford them investor protection. It would give small business an instrument that is cost effective.

I will give you an example. In the State of Georgia, where I reside, over the last 5 years there were roughly 200-and-something, low 200s, Rule 504 offerings filed with the Secretary of State. There were only 32 offerings that were completely subscribed, and out of that 32, 80 percent of them used an underwriter. The bottom line is that even if you do get through and you put a registration statement together using Rule 504 and you are a private company and you submit it with your State regulator and they approve it, these aren't people where their profession is raising capital. And the problem is they get through this whole process and at the end of the day, they find that they haven't raised the money. And I think in order for small business to have a way of raising capital, I think they need to use a professional.

Thank you.

Chairwoman KELLY. Thank you very much.

Mr. Gutierrez.

Mr. GUTIERREZ. Thank you very much. You just, real quickly, commented that, well, there probably are more phones than people hooked up to the internet. The fact is that people are using the internet a lot more than phones, especially to make investments. Senior citizens are a growing group of people that are using the internet.

So while you might have more phones than internet, the internet is the vehicle of use for making investments. All you have to do is turn on the TV to see all the different companies who are making offerings and competing with one another for $9.95 a trade, $19.95 a trade. It is an explosion, and it is all on the internet. They don't say "call this phone number." They say "get on the internet and make these trades." It is the quick way to do it. And especially senior citizens we have noticed have an increased—and I am surprised, because I am 47, so I am hoping the next 20 years go quickly so I can become an internet user, too, given that at the age of 47 it appears that older folks and younger folks than me, I think it is the people in the middle that don't know how to use the computer. If you are young or if you are older, it seems like that is what you are doing.

So that was kind of where I was going with my questions. But I thank you, Doctor, for your answer and for the security questions. I do want to ask a couple of questions, another one of Mr. Devine.

During the period before Rule 504 was—I am sorry. I need to also get glasses—was put into law, how many companies took advantage of it and how much money was raised?

Mr. DEVINE. I don't think anybody really knows the answer to that question. At least I haven't been able to find it. The anecdotal assumption is that a very large proportion of the capital for small public firms was raised through Rule 504. Since these were only required to be listed in States—and in New York didn't have to be listed at all, and I think the Securities and Exchange Commission correctly got rid of that exemption—nobody really knows. But, at least anecdotally, it was a very large proportion of the funding of small public companies.

Mr. GUTIERREZ. OK. I have a question, another question, for my fellow Illinoisan. You expressed in your testimony another issue that affects particularly advanced small businesses such as yours in the Investment Act of 1940, which requires public companies to hold up to a maximum of 40 percent of their values in the securities of other companies. How do you think this law can be amended and/or improved to better serve the current needs of companies such as yours?

Mr. HALPERN. Well I think that is an excellent question, and Ms. Sweeney, I think, made a good point about the Investment Act. And just really the purpose of the Investment Act was to manage and regulate the mutual fund industry. And we clearly are an advanced small business, as we had said earlier. I mean, these are companies that have grown much quicker and are trying to help companies in a much earlier stage and have very little to do with public investing and mutual funds. I think that the Investment Act of 1940—not the Investment Act, but the NMSIA, the 1996 National Market Securities Improvement Act, clearly gives some latitude. It gives latitude to allow companies to be exempt from some of those processes, and when we go through that department, what happens is they really don't know what to do with us. I get that feeling. I don't get the feeling that there is somebody there that is antagonistic. They are just saying "How do we fit you into that mold from 1940?" And since they can't figure it out, every time we reinvent ourselves to try to suit it they say, "Well, gee, then you have a problem with accounting." And if we change the accounting by restating financial statements, then they say, "Well, then you have a problem with the Investment Act." And then, if you have a problem with the Investment Act, but you are operating as an Investment Act company, and you do that for an extended period of time, then you have to go the enforcement department and have an enforcement action because you are out of compliance.

So these processes are neither effective or economical for anybody in the Government. And I generally—if I were—I am trying to put myself in a staff member's shoes and say, well, if I was them looking at me I would say all I have got is oranges and apples in my bowl and you are a kiwi. Well, there are a lot of kiwis now and they need a bowl.

And I don't know if this helps you, but I think something that is a very good point here is, I think this subcommittee and the Securities and Exchange Commission have an opportunity to do for the Securities and Exchange Commission and to do for small business what was done a few years back for the IRS, where if you think about it, you know, if you are already collecting upward of 40 percent of someone's hard-earned income and in addition you are taking 20 percent of their after-tax family budget in hidden regulatory costs, you would think that it pays to be very nice to those people, because they are working hard so the money can be distributed, so the Government can proliferate and do a good job managing its interests.

But I think that in the case of the Securities and Exchange Commission, it is like an accident out on the highway. Two cars crash, nobody knows whose fault it was—and I am not here to say it is anybody's fault, because I don't think there is any fault. I just think we have a process which clearly doesn't work. And if you ask me to summarize, what I would tell you is, it could work, but somebody there at the staff has to let it work. They don't know it is OK to let it work.

No-action letters? Well, those are irrelevant, because everyone has a disclaimer at the bottom that says "By the way, if we change our mind later, then this doesn't apply any more." And those disclaimers are continuously put into every single process at the staff. I don't think it is from the intent to harm small business, I think it is the reality of the regulatory machine that has built itself up into a corner and put a lot of tape around it. And so they can't see a clear way to do this.

But I clearly represent the 21 million small business professionals who have businesses, and many of them avoid altogether, or once in the process, drop out because it is too costly, it is too time-consuming, it doesn't produce the desired result. So I am calling for a process to assist the Securities and Exchange Commission in continuing on with its mission to protect investors.

I think Mr. Steinkirchner made some excellent points about how investors could be protected in the smaller markets, but give more stimulation. And I think what you get then is like we said with the IRS. Now if you call the IRS, you get a friendly process. A few years ago that wasn't the case. I think there should be a spirit of cooperation and a friendly process that we can participate in and grow these economies of scale and produce, as was mentioned earlier, a transparent process using what the other panelists have quite accurately said, the internet process.

Mr. GUTIERREZ. I think that we will be delving into that issue. Let me say the only Federal regulator I have to deal with is the Federal Election Commission in terms of keeping my reports, and we have gone online. And since we have gone online it certainly has helped us and everybody gets to know what I am doing and the information, and it has worked pretty well. But they are not—they haven't been particularly cumbersome over there. I mean, if they raise a question about a $10,000 contribution to the Democratic Party of the State of Illinois, we kind of write them back. But that is where I spend my money, my legal money, dealing with the—unfortunately I have to spend money, because they raise an issue and, of course you don't want your opponent to raise it later on and you want to be within the law—only to find out that they were wrong, that I could indeed give that $10,000 to the State Democratic Party and that they made a big thing. But in this particular case, don't worry. All the Democrats in Illinois gave the same $10,000. So we all got the same letter. So we figured if we are in trouble we are all in trouble together.

But it does cause anxiety. I mean, the anxiety that it causes is something that I want to relieve for investors out there that are developing businesses that I don't—it causes—you know, your lawyer calls you, "call your lawyer." It is like everybody is in a panic that you have done something wrong and illegal, and I want to make sure that we can get through that process in a manner in which investors can—especially that are trying to run companies, especially small businesses. They have got a lot of other things to deal with than a lawyer calling them panicked that they are out of regulation, that somebody is going to come down hard on them.

And so, thank you so much to all the panelists for coming here on behalf of the minority. Thank you very much.

Chairwoman KELLY. Mr. Shows.

Mr. SHOWS. Thank you, Madam Chairwoman.

Mr. Halpern, I was reading your testimony, and Mississippi has a lot of startup small businesses going even though we are a small State. And one of the questions I would like to ask you in your statement, and I will read the question first, is what do you think the main factor affecting the responsiveness of the Securities and Exchange Commission to the needs of small business—this probably is outdated laws, and maybe undertrained personnel or disorganized regulatory structure or maybe a tracking system. But your statement says here, when you were trying to get your money and raise capital, you said "staff members continue to contact our service, saying they still do not understand the nature of our business." I find that true in dealing with reporters sometimes, in that when you try to explain—as a Highway Commissioner back in Mississippi, I tried to explain a project to a reporter, who may be a young reporter, who didn't really understand what I was trying to tell them and I didn't know how to break it down where you didn't make them feel bad about asking that question. And I know that is probably the same problem that you have.

How do you explain to the Securities and Exchange Commission what you are trying to do and yet get it to where they can understand where they can write the guidelines for you to perform like you would want to? And that is what I am interested in, is trying to let small business be able to come in and work with the Securities and Exchange Commission and so we still have the—and I guess what everybody else is talking about—you know, simplify it enough so that the company doesn't get like you did, so disheartened with the system that you almost throw the paper up and walk out the door. And we need to turn that around. And what would you say would be the thing that we need to do to the Securities and Exchange Commission to help them to help small business?

Mr. HALPERN. Well, I think that is an excellent point that you are raising, and it brings back to mind two of the different approaches that we have discussed here. One is that in the short term I would like to see the processes that are in place be used the way I believe that they were intended to be used. In other words, in the National Market Security Improvement Act of 1996, clearly that is an act of Congress which said the Securities and Exchange Commission will consider efficient competition and capital formation in its rulemaking activities. But I don't think there is any spirit of cooperation there, because as the internet evolved there became a sort of fanaticism within the staff that there must be a lot of scams there. In fact, I attended one of these Securities and Exchange Commission meetings, an enforcement meeting in New

York early-on, about 2 years ago, and one of the marketing people from the staff got up and said, “Well, you know, people think that you know we are not on it. We don’t have enough people to keep track of all the scams out there. But actually we are way ahead of it. We have hired hundreds and hundreds of new people, and we are on it all the time.” And what I think it became was a fishing expedition. And again, you know, not with the intent, but the idea that, well, with the internet evolving there must be all these scams. And sure, there are scams. But as I said before, and I want to reestablish this point, you cannot legislate risk out of existence. But you can legislate the future of small business out.

So that was the first point. The point was let the systems that are in place do what they were intended to do. First, you need a person in there that says, “Now wait a minute, we have a process that could work.”

Regulation SB was designed, and it was released in 1992, because in the late 1980s, banks started tying up the coffers on lending to small, new, emerging companies. And you have seen this. So they said we are not going to lend. So in response, Congress said let’s do Regulation SB. And so SB was designed for small business to have an easier and friendlier process. The problem is, it is not an easier and friendlier process. In fact, if you go in and say “I am a small business,” they say, “Ooh, I don’t know what that means to me, other than I don’t have a bowl to put you in.” So you will have to go around and around the staff. In our case, the first registration process was successful, but the second one wasn’t because it took too long to get through. And by that time, most of my competitors had lost 98 percent of their initial value of a year earlier. Now, we had the distinction of funding 10 companies in that process. And today our 10 companies stand tall, have strong beating hearts and have grown and thrived in a down market, which I think says something about we are more of a traditional style of business rather than the dot.com that, you know, selling buzzwords such as B2B, B2C infrastructure. But with your small businesses that are in your home State I think it is critically important that they have a process.

Maybe the Rule 509 prepared by my collegue would be an earlier stage process. They must be inspired though, no matter what the process, to follow the process that should work. And when the company gets in the process, I think they should be embraced. If you come here to Washington to the Securities and Exchange Commission and you say “I am a small business,” I think you should have a red carpet thrown out and say, “You are going to create more jobs and more money for our staff to run itself and take care of real problems. So therefore, we embrace you.”

But it is really not that way. It is more of a mean-spirited approach, saying “We don’t really understand, therefore we will shuffle you around and see what happens.” And you know, I survived it. OK. I am here on my dime to come here because you were willing to take your time and listen. But I think it is a critically important issue. And I think, step one, let’s make the processes that are already in place work. They have latitude. Let’s give latitude. Let’s get rid of these things. Let’s give latitude to this BDC. Let’s give latitude to investors and let’s make them work. My second phase will give the Small Business Advocacy and Liaison Office, the 19th office in the Commission, a long-term latitude, a long-term communication process that would allow us to keep track of what is going on and make sure that there is a special interest group within the staff that always says no matter what rules are going on, you know, we have a process to help the small business get through so it can become a big business some day and create more jobs and more economy and more value.

Mr. SHOWS. But don't you think that is the intent of Congress, but the mindset of some of the Securities and Exchange Commission is still set this way and not initially the intent of Congress? We would like for it to work. Like you said, it is in place. Now, why isn't it working? Is it because some of the people have been there so long their mindset is set in that fashion?

Mr. HALPERN. Yes.

Mr. SHOWS. And they are locked in and they don't feel like they are going anywhere?

Mr. HALPERN. Yes. I think it is as frustrating for the staff as it is for us out here. You know, they may not be aware of it, because they will go home and come back every day, you know, going to the same job, not being concerned in the least with what the outcome is. But we are concerned because it is our business. I think this is an issue where we all can say yes, we get it. We have to figure out a way to help small business and achieve the desired result. And I think given that opportunity the staff would say, "OK, give us some clear instructions on how to handle these other entities and we will do it."

Mr. SHOWS. Thank you.

I appreciate it, Madam Chairwoman.

Chairwoman KELLY. Thank you, Mr. Shows.

Mrs. Jones, have you questions?

Mrs. JONES. Yes.

Good morning. I missed some of your presentation and I am trying to quickly read through your statements to kind of catch up here. I also sit on the Small Business Committee, so the combination of these two works very well. I am trying to, in my second term in Congress, improve. I come from the City of Cleveland and we are always looking for more capital investment in Cleveland. So if you don't have any investment in Cleveland—I don't have a company, but please come on in and do some work because we need it.

Let me also say, I think that small businesses are key to creating stronger communities throughout this country. We have had great success in building new homes in Cleveland in many communities, but we need some businesses to go with those new homes to really create a community.

Ms. Sweeney, I am looking at your statement, and you speak about not being able to use an integrated disclosure for purposes of your shelf registration statement and other things. Are there other examples of improvements that you can suggest that the Securities and Exchange Commission could do in order to assist small business in working its way through the process?

Ms. SWEENEY. Yes. I will answer that and also follow up on some of the points Mr. Halpern made.

Mrs. JONES. No problem.

Ms. SWEENEY. I have kind of got an interesting background myself, because I was with the staff of the Securities and Exchange Commission.

Mrs. JONES. I read that.

Ms. SWEENEY. In the Enforcement Division, and I have got to tell you, there are lot of bad people out there and there does need to be a very strong Securities and Exchange Commission that does protect the widows and orphans, because there are a lot of scam artists out there. So regulation, I think, is a good thing.

What I think has happened to our Securities and Exchange Commission, and I think it has happened more in the decade of the 1990s than you saw in the 1980s, is there has been a misplacement of emphasis and a misplacement of leadership at the core of the Securities and Exchange Commission to focus time on interpretive positions, rulemaking, and exemptive orders, because we are dealing with a body of law that is 70 years old. The capital markets move. Law can't possibly keep pace with the speed of the capital markets. Death spiral preferred is a classic example. This is a preferred stock instrument that is killing common shareholders. How can people at the Securities and Exchange Commission stay on top of that if their time is spent in low value-add activities like reviewing registration statements?

There is a ton of very, very talented staff members at the Securities and Exchange Commission that have the capabilities to spend their time thinking of interpretive positions, rulemaking and ways to increase access to capital. But when their hours, their daily work hour is spent pouring through these—do you know I have to file one of these every quarter and someone has to review it? I mean, when that time is spent doing that, how can they have time to think of the bigger picture and think about how to push access?

So it really is a very simple change. It is a change in emphasis from low value-add to maximum value-add, and that is really all that needs to happen.

Mrs. JONES. OK.

Mr. Devine, or Mr.—want to pronounce that for me?

Mr. STEINKIRCHNER. Steinkirchner.

Mrs. JONES. Steinkirchner. Would either of you like to add anything based on what we have discussed before my time is up?

Mr. DEVINE. On the question of the Securities and Exchange Commission itself, I will speak as somebody with some background in Federal personnel, being in charge of it at one time. Bureaucracies aren't known for quick response. I mean, that is kind of the nature of bureaucracy. And the Securities and Exchange Commission is no better or no worse than probably any other bureaucracy, maybe a little better than most. But the problem is that changing ways of thinking in a bureaucracy is enormously difficult. And I think the history of the 1996 Act, in Chairman Oxley, and former Chairman Bliley's attempt to get the Securities and Exchange Commission to respond, in the kind of response that in my opinion was enormously inadequate, you can see right there reading it—that they are not responding—or in reading the cost-benefits section of the change to Rule 504. I mean, you can see they just don't get it. And I don't think it is necessarily a bad spirit; but they just don't get it. And that is why these hearings, to me, are so important.

The Congressman from Mississippi—I am afraid, unlike Mr. Gutierrez, I am already old, so I can't read his name. I apologize.

Mrs. JONES. Shows. Ronnie Shows.

Mr. DEVINE. He asked, "Congress didn't intend." And that is very clear. Congress intended the Securities and Exchange Commission to look at the broader picture. And in my experience in this business, the only way you can do it is you keep going back and telling them again and again. That is why my every other word is thanking you for having this hearing.

Mrs. JONES. Do I have a moment to allow the last gentleman to respond?

Chairwoman KELLY. Of course.

Mr. STEINKIRCHNER. Thank you. Well, I will give you two conviction solutions, one a standardization of the offerings. The reason why that book is as big as it is is because the Securities and Exchange Commission asks you to put what is pertinent that investors should know. But that is all they say. They don't tell you exactly what is needed to be put in that document. And I think if they found what was necessary for investor protection to put into a document of that nature, that would go down dramatically, and I think Ms. Sweeney would probably agree with me.

Two, education. If we want people to stop getting burned over the internet or through whatever, we need to educate the public a lot more about private and public offerings, and that is the number one way. I mean, we have been harping for—I don't know, 20 or 30 years, to use seatbelts and now people are using seatbelts. And I think if we harp on them that, "Hey, I think you should get a registration document, here are 10 things that you should look at before you place money in a private company," or a public company or whatever, and harp this continually, I think you will cut down the amount of scams and frauds that are occurring over the internet, through the mails, and over the telephone.

Mrs. JONES. Thank you.

Chairwoman KELLY. Thank you very much, Mrs. Jones.

If there are no more questions I am going to note that some Members may have additional questions and they may wish to submit them in writing. So without objection, the hearing record is going to remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

I really thank this panel. You have been extraordinarily patient with us. We do have more questions I am sure. You have also been very interesting in your responses, and we do thank you for your indulgence in allowing us a second round of questions here.

This panel is excused with our great thanks, the subcommittee's great thanks, and appreciation for your time. This hearing is adjourned.

[Whereupon, at 11:15 a.m., the hearing was adjourned.]

A P P E N D I X

June 26, 2001

Statement of Chairwoman Sue Kelly
House Committee on Financial Services
Subcommittee on Oversight and Investigations
Hearing on the SEC's Role in Capital Formation:
Help or Hindrance?
June 26, 2001

This hearing of the Subcommittee on Oversight and Investigations will come to order. Without objection, all members' opening statements will be made part of the record.

This morning we are holding this Committee's first hearing on the issue of capital formation. Capital formation has been an implicit responsibility of the SEC since it was first created. In 1996, securities laws were amended by the National Securities Markets Improvement Act to explicitly state that capital formation is an important responsibility of the SEC. In 1995, in testimony before the former Subcommittee on Finance and Hazardous Materials, former SEC Chairman Arthur Levitt stated, "Existing law already requires the agency to give consideration to efficiency, competition, and capital formation concerns whenever the Commission is required to make a public interest determination."

The securities markets are the critical force behind our nation's economy. It has been one of my long-standing goals in Congress to eliminate obstacles to capital formation in those markets, especially for small businesses. I am greatly distressed by concerns that fundamental regulatory obstacles are inhibiting the flow of capital to, and investor participation in, the small and middle-market business sector. This hearing is the Subcommittee's first step in determining how we in Congress, and the Commission, can effectively eliminate those obstacles -- for all participants in our nation's capital markets.

Capital is the lifeblood of business and the efficient access to capital is a crucial ingredient to a strong, growing economy. We have the responsibility to closely examine the different structures the SEC has crafted for businesses to access the markets and determine if these are practical and effective. Businesses should be able to devote their energies towards their customers and not be delayed by unnecessary requirements that no longer reflect the realities of our new economy. In the SEC's work to ensure investor protection and efficient capital formation, I believe the best service they can provide is to ensure transparency in disclosures and ensure fair play through their enforcement division.

A September 2000 General Accounting Office report found that the estimated average total costs needed to conduct a small business IPO during 1994-1999 was about 10 percent of the total offering proceeds, while the average total costs for a large business IPO was about 8 percent. The SEC has a few different processes for smaller businesses and smaller offerings which were designed to reduce the regulatory burden for these issuers. We will examine the effectiveness of some of these processes here today.

In addition, in 1996 the SEC was given general exemptive authority to allow them to waive specific requirements on a case by case basis in order to give the SEC additional flexibility in assisting businesses access to the capital markets. I intend for this Subcommittee to take a close look on how that authority is being used.

Before us today we are honored to have a distinguished panel of witnesses to share their thoughts and observations with us on these issues. I thank you all for taking the time out of your busy schedules to discuss these issues with us.

I would like to let members of the Subcommittee and their staff know that it is my intention to enforce the five-minute rule and would appreciate their cooperation in this.

I will now recognize my friend from Chicago, Mr. Gutierrez, the distinguished ranking member for this Subcommittee, for his opening statement.

The Washington Times
June 26, 2001

DONALD DEVINE

SEC sleuths beyond the law?

Rep. Michael G. Oxley, Ohio Republican, has been trying to get the Securities and Exchange Commission to follow the law ever since the National Securities Market Improvement Act (NSMIA) was passed in 1996. Now that he is House Financial Services Committee chairman, he and subcommittee Chairman Sue W. Kelly, New York Republican, will hold an oversight hearing today to uncover the reason for the lawlessness.

In April 2000, Mr. Oxley wrote to Arthur Levitt, then the Securities and Exchange Commission chairman, asking if he had followed the 1996 legal requirement to "also consider, in addition to the protection of investors, whether [SEC rule-making] action will promote efficiency, competition and capital formation." After receiving the Levitt and SEC staff response in a May 24, 2000, letter, Mr. Oxley concluded that current SEC practice "does not meet that standard." Reading the SEC response, one is forced to agree. This SEC disregard for the law continues to this day, provoking the hearing.

There is nothing more important to the economic prosperity of the United States than capital formation. It is the engine that feeds the creation of jobs, supplies earners with additional income, and accumulates savings for retirement. Yet, the government agency most responsible for overseeing the capital markets does not take the economic effects of its rule-making on capital formation into account when it exercises its powers of regulation. This is a public scandal.

The most serious example of this mode of thinking occurred in 1999 when the SEC effectively eliminated its most important capital-generating initiative by eliminating public offerings from coverage under so-called Rule 504. This little-heralded rule was passed by the Reagan SEC on April 15, 1982, and empowered small business to raise up to $500,000 (later raised to $1 million) of essential capital with limited bureaucratic red tape. This one rule may have had as much to do with the nearly two-decade boom starting in the early 1980s as any of the more well-known contributing factors. Yet in 1999, the SEC eliminated this source of capital for public companies and, with the NASDAQ Over the Counter Bulletin Board, required them to report to the very bureaucratic SEC rather than the states (which approved stock offerings within a few weeks rather than months).

The result of these changes was that efficient, low cost, public Rule 504 capital offerings were denied to all companies and 2,982 companies were thrown off the OTCBB into the more turbulent "pink sheet" market, or worse, into bankruptcy. This pink sheet market is the same one that during the penny stock scandal was reputed to have a fraud rate of 20 percent.

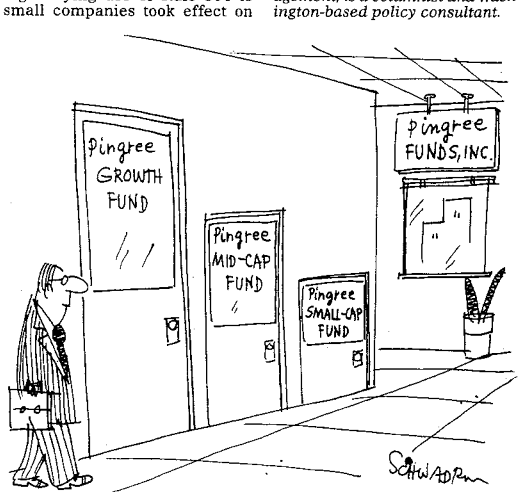
This rash action was taken even as the SEC acknowledged that the original "scope of the abuse is small." In other words, in the name of fraud protection, the remedy was to throw the overwhelming number of companies that were not engaging in fraud into a less regulated market where they were more subject to fraud. It is understandable that the private OTCBB would desire to have its own market as free from abuse as possible and to wantonly cast out the good (but poorly capitalized) companies with the bad. The supposed rationale for the very existence of the SEC, however, is to look at the larger public good.

The result was disastrous. With all stock markets pushing up through March 1999, the SEC's ruling denying use of Rule 504 to small companies took effect on April 7, 1999. From that date until the OTC eligibility period ended, there was great instability in the small cap market for those companies awaiting SEC and OTC action. After the OTC action was finalized on June 28, 2000, the NASDAQ small-cap market dropped like a rock to the bottom, while stocks generally continued to boom. Small-cap stocks have not recovered to this day.

Given the cavalier manner in which the SEC's cost-benefit analysis was performed, it is not unreasonable to conclude that the SEC, in fact, ignored the NSMIA requirements. It is hard to fathom that the final change for Rule 504 was published two days after the chairman of the predecessor committee reminded the SEC that it should consider the NSMIA changes in any rules it adopted, and that oversight hearings would be held "to ensure that final rules are consistent" with it. It is almost contempt for Congress.

Let the hearings begin. Reps. Obey and Kelly must now make the SEC follow the law and assure that this destructive economic dislocation never is caused by the government again.

Donald Devine, former director of the U.S. Office of Personnel Management, is a columnist and Washington-based policy consultant.



Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services
Subcommittee on Oversight and Investigations
June 26, 2001

"The SEC's Role in Capital Formation: Help or Hindrance?"

I thank the Chair and applaud Subcommittee Chairwoman Kelly for holding this morning's hearing.

One of the most important roles of the Financial Services Committee is effectively exercising the oversight authority with which the Constitution charges us. This Committee has been, and will continue to be, aggressive and active in its work to ensure that the Federal securities laws effectively serve investors and our capital markets.

In light of the technological and other changes that have transformed our marketplace in recent years, it is time to take a close look at the regulatory structure governing our securities markets. Accordingly, this is the first in a series of hearings that will examine the implementation of the Federal securities laws. I thank the Chairwoman for her leadership in this very important mission.

While everyone knows that the Securities and Exchange Commission is authorized by the Congress to protect America's investors, it is important to recognize that part and parcel of that mission is the promotion of capital formation.

Capital formation is the engine that drives the economy by enabling companies to grow, create jobs, and innovate. Because regulatory hurdles to raising capital harm our nation's economy, it is important to examine whether the current rules and regulations foster efficiency and competition. Regulatory hurdles to capital formation also harm investors -- by making it more expensive for them to access the capital markets and by reducing the investment opportunities available.

For example, some market participants who seek to raise capital through an initial public offering of shares to the general public contend that the costs of accessing the market are greater for small issuers than for large issuers. The importance of small business to this nation's capital markets cannot be understated. As one of our witnesses today points out, small businesses produce over half of the country's gross domestic product, and employ over half the workforce. Obstacles to capital for these entrepreneurs translate directly into lost opportunities, fewer jobs, and less productivity.

Accordingly, it is our mission to identify and rectify the problems that our regulatory structure creates for not only small business, but all market participants.

In 1996, the Congress took an important step toward reducing regulatory obstacles to capital formation. In the National Securities Markets Improvement Act, the Congress expressly charged the Commission with the mandate to consider "competition, efficiency, and capital formation," in addition to investor protection, in its rulemaking.

In addition, the Congress provided the Commission with broad exemptive authority under both the '33 and '34 Acts. That authority was granted to provide the Commission with a tool it could use to reduce regulatory burdens.

Today, we will hear from a distinguished panel of witnesses who will provide their views on whether the SEC has satisfied its statutory requirement to facilitate access to our capital markets. I look forward to hearing their opinions about whether the Commission has used the regulatory tools available to it to accomplish that goal.

I also look forward to hearing their suggestions as to what the Commission, or the Congress, can do to better promote capital formation and provide our nation's investors with more opportunity – and a stronger economy.

I'd like to thank all of our witnesses for appearing here this morning. I yield back.

OPENING STATEMENT OF
LUIS V. GUTIERREZ
RANKING DEMOCRAT
SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS
THE ROLE OF THE SEC IN PROMOTING
CAPITAL FORMATION: HELP OR HINDRANCE
JUNE 26, 2001

Good morning Chairwoman Kelly and thank you for holding this hearing. I would like to welcome all of the panelists who have come here today to share their views on the important issue of capital formation. I am pleased to be here today.
The mission of the U.S. Securities and Exchange Commission is to protect investors and promote efficient capital formation. The challenges facing the Commission in accomplishing its mission are no different today than the challenges that existed in 1933, when the U.S. federal government first began regulating issuance of securities. The premise of the ?33 Act is that full and fair disclosure will most effectively promote efficient and fair functioning of the process of capital formation.

We are here today to study and discuss possible changes to the existing regulatory structure to facilitate capital formation for small businesses and all market participants.

Small businesses are an important source of economic growth and job creation. They account for 50 percent of the gross domestic product and the majority of new jobs created. In terms of innovation, it is estimated that small firms produce twice as many product innovations per employee as large firms, creating new products, services, lines of business and industries.

Access to capital is a critical issue for small businesses. Without sufficient capital, small firms are unable to develop new products and services or grow to meet demand. Insufficient liquidity is a frequently cited cause of small business failure. Small firms are heavily dependent on bank loans, trade credit and informal sources of financing such as personal savings, credit cards, home equity loans and loans from family and friends.

Steps have been taken by both federal securities regulators and state governments in an attempt to reduce some of the regulatory burden and costs for small businesses seeking equity capital financing in the regulated securities market. One of the steps taken by federal securities regulators has been simplifying federal registration of securities offerings and exempting certain small business securities offerings from several requirements (Regulation D) in an attempt to reduce the regulatory burden and costs for small businesses in equity capital formation.

One of these exemptions, Rule 504 under Regulation D, is intended to allow companies to raise

seed capital. A company may privately sell up to $1 million of securities in a 12-month to any investor without registration as long as there is no public solicitation or advertising and resale of the shares is restricted. A company may sell the same amount of securities using public solicitations if it has registered the securities in a state that requires
(1) public filing of a registration statements with the state and (2) delivery of disclosure documents to investors.

From 1992 to 1999, the SEC dropped the state registration requirement from Rule 504. They then experienced a substantial increase in the number of complaints they received from investors who had been defrauded by operations selling shares under Rule 504. The SEC found that fraudulent operations had developed that would go to states that had no substantive registration requirements and sell securities to residents of those states. This resulted in substantial incidents of fraudulent sales to the general public of
securities for which no information was publicly available.

Another step taken by the SEC to minimize the regulatory costs of raising equity capital, has been permitting small business issuers to use simplified small business forms (the so-called SB-1 and SB-2) in filing registration statements. Small business issuers are those with less than $25 million in revenues in the last fiscal year and outstanding stock of $25 million or less.

Even though these forms save an issuer up to approximately $125,000 for an average offering, small business issues are viewed unfavorably by many investment bankers because they are too small in size to be profitable. Also, small offerings are commonly distributed by smaller investment banks that lack market recognition, which can be an impediment to attracting investors.

These problems show that even though many positive steps have been taken to help small businesses gaining access to equity capital, more needs to be done.

By passing the Capital promotion tools in the National Securities Markets Improvement Act in 1996, we sought to enhance the Commission□s role in promoting capital formation and efficiency with the appropriate investor protections. It is crucial then that the SEC balance the burden placed in small businesses against the purposes of investor protections under the securities laws.

I look forward to hearing all of the testimonies.

Thank you Madame Chairwoman.

EXECUTIVE SUMMARY OF

"MODERNIZING THE REGULATION OF

BUSINESS DEVELOPMENT COMPANIES"

A Forthcoming Report by

The Committee for Modernization of BDC Regulation

June 26, 2001

EXECUTIVE SUMMARY

Legislation enacted in 1980 amended the federal securities laws to reduce regulatory obstacles to public investment in professionally managed funds that provide capital to small, growing businesses. The vehicle identified in provisions added to the Investment Company Act of 1940, as amended (the "1940 Act"), to fulfill this purpose was the "Business Development Company," or "BDC."

Historically, private equity investing has been, and to a significant extent continues to be, the province of institutions and wealthy investors either through private funds or direct investment. This circumstance existed because a private fund would have been required to register under the 1940 Act if it accessed the public markets and thereby would have become subject to a regulatory regime that would have made operations impracticable. Legislation enacted in 1980 was designed to "remove SEC regulatory burdens on venture capital activities that might create unnecessary disincentives to the legitimate provision of capital to small developing businesses . . . ."[1]

Congress' intent in creating the BDC structure was to encourage the flow of public capital to small, private companies. This was to be accomplished by providing BDCs with greater operational flexibility than was available under the 1940 Act to traditional registered investment companies (*e.g.*, mutual funds and closed-end funds). Specifically, BDCs were granted greater latitude in using leverage to enhance returns and were allowed to issue options, warrants and rights to subscribe or convert to voting securities (collectively, "derivative securities") in order to incentivize management, two hallmarks of private equity fund operation.

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[1] 126 CONG. REC. 26,545 (1980).

In return for this greater flexibility, BDCs were required to (i) invest a substantial portion of their assets in small and growing companies and (ii) comply with the registration and periodic reporting requirements of the Securities Exchange Act of 1934, as amended (the "1934 Act"), generally to the same extent as operating companies, including traditional finance companies.

The BDC approach to public investment in private companies is, as envisioned by Congress, sound and workable. To date, a number of such entities have been able to make a difference in the lives of emerging businesses throughout the country by providing them access to a source of capital – the public equity capital market – that would otherwise be unavailable to them. However, despite its record of successfully providing small business financing, the BDC industry is still barely visible, eclipsed by the growth of private equity funds with which BDCs compete. According to industry observers

> [t]he BDC law has been a dismal failure . . . . A mechanism needs to be developed that will make available to small companies the pool of money that comes from ordinary or retail investors. While the BDC program was developed with this goal in view, it was not successful.[2]

The failure of the BDC program is largely attributable to the fact that the regulatory regime under which BDCs operate is overly restrictive, thus placing BDCs at a distinct competitive disadvantage compared to other providers of small business capital. These other providers of small business capital have prospered, particularly in the past decade, while the growth of the BDC industry has languished.

Private equity funds, like BDCs, provide financing to small, developing businesses in exchange for an equity stake in the enterprise, or provide debt financing. BDCs also perform a function typically engaged in by private equity funds, namely participating in the management

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[2] SEC Government-Business Forum on Small Business Capital Formation, Final Report, at V.3 (July 1999) <http://www.sec.gov/smbus/finrep17.htm>.

and development of their portfolio companies. Because BDCs and private equity funds share similar investment models, the nature of their investment portfolios and the types of investment professionals they employ are similar as well. Notwithstanding these similarities, BDCs and private equity funds differ significantly in that private equity funds operate so as to avoid regulation under the 1940 Act. The resulting freedom from 1940 Act regulation of operations and compensation has enabled private equity funds, as an industry, to thrive whereas the BDC industry has languished. This result, which was certainly not intended by Congress, has effectively deprived small, developing businesses of the important source of financing – namely that of retail investors – that the BDC model was designed to provide.

The recent rise to prominence of Internet incubators illustrates the public's demand for participation in the private equity market and underscores the fact that the current regulatory regime for BDCs has crippled their ability to effectively compete for investor dollars. BDCs and Internet incubators share similar investment models and offer their portfolio companies significant managerial assistance. However, because Internet incubators avoid 1940 Act regulation, either by managing their assets so as to remain outside the objective tests for an investment company or by obtaining a determination from the Securities and Exchange Commission (the "SEC") that they are effectively not an investment company, they enjoy greater flexibility with respect to operations and compensation practices than do BDCs. Indeed, according to the companies operating as Internet incubators as recited in their filings with the SEC, remaining outside of 1940 Act regulation is essential to the effective operation of an Internet incubator.

The purpose of the Committee for Modernization of BDC Regulation (the "Committee") is to advocate for modernization of the regulatory scheme under which BDCs operate to make

BDCs more competitive in the capital markets. The Committee believes that the BDC model is well conceived and has proven to be workable. However, BDC regulation has remained static in the twenty years since the legislation creating BDCs was enacted, leaving BDCs ill-equipped to compete in the constantly changing markets in which they operate.

As discussed below, current BDC regulation hinders BDCs with respect to the following types of activities, which are critical to their successful operation:

- Compensation. BDCs are restricted in the types and amount of equity compensation that they can pay their employees; therefore, they must pay higher cash salaries in order to compete for private equity investment professionals. These professionals increasingly display a preference for more equity in the firm, or the firm's portfolio companies, over higher cash compensation because of the potentially greater long-term rewards. Furthermore, paying higher cash compensation means that a BDC has less capital to finance further investment in small, growing businesses, which in turn hinders the ability of the BDC to grow.

- Access to Capital. The flexibility to regularly access the public capital markets in a nimble and efficient manner, which has become an accepted way of life for seasoned public companies in today's economy, has never been made available to BDCs. Among other things, BDCs cannot use their periodic reports as a means to update their registration statements, which makes conducting a registered public offering for a BDC with an operating history and substantial market capitalization unnecessarily cumbersome, time consuming and costly. BDCs, regardless of their eligibility to do so, are precluded from registering their securities on such abbreviated registration forms despite the benefits that would inure to BDCs' shareholders.

- Operations. BDCs are required to invest primarily in securities of "eligible portfolio companies," which generally are domestic companies whose securities are not marginable. The definition of an eligible portfolio company, which has not been amended in the twenty years since the legislation creating the BDC model was enacted, unnecessarily restricts the universe of businesses in which BDCs can invest. In addition, BDCs are required to obtain exemptive relief from the SEC to engage in certain activities or transactions that are otherwise prohibited. Certain of these activities (*e.g.*, issuing derivative securities to directors who are not employees or officers of the BDC) are routinely engaged in by BDCs and the granting of exemptive orders for these activities is rather perfunctory. However, the exemptive order process is time consuming and costly to a BDC.

- Taxation. Like traditional open-end and closed-end funds, BDCs can qualify to distribute ordinary income and long-term capital gains to shareholders free of federal income tax at the corporate level. The qualification requirements, however, do not reflect the long-term nature of investments that BDCs make and consequently BDCs often have great difficulty qualifying for the preferred tax treatment.

BDC regulation needs to be updated and revised to ensure that BDCs will be able to provide small and growing businesses with a reliable source of financing and provide retail investors the opportunity to participate in private equity investing. The Committee endorses the following modifications to BDC regulation:

- elimination of unnecessary restrictions on compensation that are inconsistent with the effective operation of a private equity investment vehicle,
- removal of barriers to the capital markets, and
- the easing of certain restrictions on operations in a manner consistent with the protection of BDC shareholders and the retention of public confidence in the capital markets.

Without these changes the viability of BDCs as an industry is in doubt, which threatens to undermine Congress' goal to provide small business with a viable alternative source of financing and preclude retail investors from participating in private equity investing.

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TESTIMONY OF

JOAN SWEENEY

CHIEF OPERATING OFFICER,

ALLIED CAPITAL CORPORATION

**BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
SUB-COMMITTEE ON OVERSIGHT AND INVESTIGATION
OF THE
COMMITTEE ON FINANCIAL SERVICES**

June 26, 2001

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STATEMENT OF JOAN SWEENEY

Madam Chairwoman, members of the Subcommittee, my name is Joan Sweeney and I am the Chief Operating Officer of Washington, D.C. - based Allied Capital Corporation, a publicly traded private equity investment fund. Today, I am very pleased to have the opportunity to discuss the effects that the federal securities laws have had on Allied Capital's ability to provide an alternative source of capital to illiquid private and illiquid public growing businesses which are so essential to the health of the nation's economy, and to share some of our specific experiences.

I wanted to speak to you today about the need to challenge and modernize the federal securities regulatory framework with the goal of enhancing the capital raising process while maintaining investor protection and encouraging investor participation in the capital markets. In particular, I want to focus on the capital raising process for growing small and middle-market businesses, an area in which the Securities and Exchange Commission and its hard-working staff (the "Staff") have made significant strides in the past few years (especially in adopting certain initiatives targeted at small business such as Regulation S-B and revising Rule 144).

The National Securities Markets Improvements Act of 1996, which provided numerous salutary modifications to the regulatory structure, noted that the purpose of the enactment was to "promote efficiency and capital formation" and to "promote more efficient management of mutual funds, protect investors, and provide more effective and less burdensome regulation." The promise of that noble purpose has, unfortunately, gone largely unfulfilled; as fundamental problems remain that inhibit the flow of capital to, and investor participation in, the small and middle-market business sector.

BACKGROUND AND EXPERIENCE

I want to specifically relate to the Committee my experience as an active market participant and as a funding source for small businesses. Allied Capital has been investing in small and growing businesses for over 40 years. We own and operate the oldest SBIC license issued by the SBA, and to date we have provided financing to thousands of small businesses nationwide. We provide both mezzanine debt and equity capital. Our portfolio of investments today is just shy of $2 billion, and our portfolio includes investments in 125 small and middle market companies. We have been able to make capital available to those businesses through a specialized business model known as a "business development company," or "BDC," which is regulated under the Investment Company Act of 1940 (the "1940 Act").

As a direct participant in the capital markets for the small and middle-market business, we clearly see the challenges faced by companies seeking to access growth capital. As a public company, we have direct experience in the cost and effort a public company must incur to access the capital markets and comply with the federal securities laws.

As an executive officer of Allied Capital, I have personally experienced the frustrations engendered by inefficient regulation. Although Allied Capital has been a successful conduit for bringing public investment dollars to small businesses, we have done so despite a regulatory regime that causes delays and inefficiencies that find no justification in the fundamental purpose underlying the federal securities laws – the protection of investors. As a former member of the

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Staff of the SEC's Division of Enforcement, I understand and support fully the need for the Commission to be the "cop on the Street." However, to be an effective regulator the SEC must not only "police the marketplace," it must also facilitate the capital formation process. And under the current regime, the SEC's underpaid and overworked Staff has neither the legal authority nor the personnel to nimbly react to the changing financial landscape.

MODERNIZATION

I would like to address some of the over-arching issues that I believe Congress and the SEC need to be mindful of in order to look forward to a regulatory regime to serve public companies and investors as we embark into the 21st century.

Embracing technology and the Internet: In a world where finance is moving at the speed of light through the Internet and information is only a "click away," the manner in which we regulate the offer and sale of securities needs to be re-examined. The fact that information is not considered public for some purposes under the federal securities laws when it is presented on a company's website seems out of touch with the realities of the Millennium – especially when much of the disclosure regime already relies on on-line "EDGAR" filings to provide the public with information about registrants. Congress and the Staff need to think "outside the box," and perhaps outside the four corners of the prospectus. The concept of a virtual prospectus that incorporates a company's website communications needs to at least be considered. The time has come for a fresh look at what makes sense.

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Emphasis on "high value-add activity" and less emphasis on "low value-add activity": Under the current, almost 70-year-old system, too much of the Commission's daily activities center around a regulatory protocol that provides for the review of registration statements associated with the initial or secondary offer of securities. I believe that this is a very cumbersome and low value-add service provided by an already overworked Staff. The law is the law, and the registrant, their lawyers, the registrant's underwriters, and their lawyers are responsible for and liable with respect to compliance with the law. Therefore, one has to question why a minimum 30-day review period, often undertaken by an unseasoned examiner, is necessary. The cost of such review can be extremely detrimental to the capital raising process, not only because of legal fees that can mount exponentially in response to questions often raised only from a lack of experience, but more seriously because of delay that can cause the registrant to miss a "market window." Time and resources are wasted on whether a registrant used the word "such" or "certain" too often.

The reality in the capital markets is that public deals are not sold off the registration statement. Although the Plain English initiative improved public disclosure documents, prospectuses are still not understood by many investors and frequently are not read. The vast majority of public securities are sold to mutual funds investing on behalf of the public, and the sophisticated mutual fund portfolio manager is researching far beyond the registration statement, and ironically using the Internet and the registrant's website. To further the irony, the individual investor is also using the registrant's website and Internet chat boards to get the "real plain English" scoop. Wouldn't it be more productive for the regulatory regime to focus its efforts on getting the information most efficiently through the channels that investors really use, rather than allocating limited Staff resources to spend countless hours reviewing an outdated registration form?

Challenge the usefulness of outdated rules and regulation through increased activity in providing exemptive orders and new rulemaking: Just as the entire registration statement process is outdated, there are many other specific examples where the current regulatory regime has not kept pace with the capital markets and is also very inconsistent in its application. Obviously, the examples most familiar to me are ones that specifically impact Allied Capital as a business development company, or BDC, and impede our ability to most efficiently provide capital to growing businesses. I am certain many of you are not even familiar with business development companies and their role in capital formation, and I believe that is directly attributable to an outdated and overly burdensome regulatory structure that is crying to be modernized.

BDCs were created by Congress in 1980 in the Small Business Investment Incentive Act. They are regulated pursuant to a customized regime under the 1940 Act. Congress' intent in creating the BDC structure was to encourage the flow of public capital to small, private companies. The BDC model as envisioned by Congress – public investment in small and growing companies – is sound and workable. BDCs, like Allied Capital, have been able to make a difference in the lives of small business owners throughout the country by providing them access to a source of capital – the public equity market – that otherwise would be unavailable.

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However, despite their record of successfully providing small business financing, the BDC industry is still barely visible. The failure of the BDC structure is largely attributable to the fact that the regulatory regime dictated by the 1940 Act and related rules is overly restrictive and outdated. BDCs struggle under the yoke of a regulatory regime initiated over 60 years ago, which prevents BDCs from competing effectively in the capital markets. The result is that the BDC industry has failed to mature, and thus, deprived small businesses of access to capital.

For example, the current regulatory framework seriously limits the ability of BDCs to continually raise new equity in the public markets – the lifeblood of a BDC. The flexibility to regularly access those markets in a nimble and efficient manner, which has become an accepted way of life for seasoned public operating companies, has never been made available to BDCs. Unlike companies not regulated by the 1940 Act, BDCs are not allowed the benefit of an integrated disclosure system, and we cannot use the information provided to the public through our periodic Form 10-Ks and Form 10-Qs to update our shelf registration statement. This structure makes conducting a public offering for a BDC like Allied Capital unnecessarily cumbersome, time consuming and costly. A publicly-held bank, for example, simply because it is not subject to the 1940 Act, can enjoy the efficiency of integrated disclosure. We believe that our inability to use integrated disclosure is a mere oversight in the law and could be easily corrected by the Staff through no-action relief or rulemaking.

My experience has been that the Staff is hardworking and professional, but they are hamstrung by a lack of time to focus on the shortcomings of regulations developed for a wholly different market place that no longer exists. Allied Capital sought a "no-action" position from the Staff to allow integrated disclosure for our shelf registration statement by a letter initially submitted on July 8, 1998. After three years of waiting, last week we were told that under the current regulatory framework, the Staff could not grant the relief we were seeking. Rather, a request for rulemaking would have to be made, with no guarantee of immediate attention or a favorable result there either. Historically, rulemaking proceedings have been far more protracted – and costly – than no-action requests. The fact that we had to wait three years to learn that we not only don't have an answer to our question, but that we must now go back to the drawing board and pursue a different bureaucratic process to see if we might get an answer is a testament to a very inefficient regulatory regime.

Allied Capital is traded on the NYSE, our market capitalization is in excess of $2 billion, we actively maintain a very comprehensive website, we have 13 sell-side analysts that follow the performance of the company, we regularly provide information to the market through press releases, and we file Form 10-Q's quarterly and Form 10-K's annually. It seems incongruous in the Internet age, that we must formally update our shelf registration statement again each quarter to incorporate our financial information when this information is only a click away. BDC's should be allowed to have the same integrated disclosure systems that other operating 1934 Act registrants have. In fact, since a BDCs fundamental purpose is to provide access to capital, we believe that the regulatory regime should be focused on ways to encourage the formation of more BDCs in every way possible, not inhibit their growth. By modernizing the way they are regulated, Congress could truly make BDCs the source of public capital for small and growing businesses that was intended in the 1980 enabling legislation.

Resources are not being properly allocated to address creative solutions to capital raising such as enhancing the BDC structure. The Staff is extremely capable, but suffers from its

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inability to respond to market changes because of often misdirected time spent on implementing numerous low "value-add" or outdated regulations. The Staff needs to be given greater flexibility to allocate its time and resources to innovate and foster capital formation through thoughtful interpretive positions, exemptive orders and rulemaking. I am certain that if the Staff had the time to focus on enhancing capital formation as well as were empowered to address requests such as ours related to integrated disclosure, we would not have waited three years to find ourselves back at square one.

Modernizing the federal securities laws and the way they are administered will only strengthen our markets and make them even more attractive globally. The perpetuation of a system rife with expense and delay cannot be consistent with public policy or investor protection.

I believe that the changes that I have suggested would provide greater access to capital in a manner consistent with investor protection.

Thank you for the opportunity to present my views on this important subject.

The Role of the SEC in Capital Formation: Help or Hindrance?

June 28, 2001

Follow Up Questions from Chairwoman Sue Kelly for All Witnesses:

1. **How Should the Internet be used to improve the capital raising process?**

The Internet should be embraced as the principal means of providing disclosure to investors. We need to think outside the box and outside the four corners of the prospectus to come to a "virtual" prospectus that incorporates a company's website. Right now, company websites can be used to find all of the same type of information contained in a prospectus – and the information is generally presented in a much more plain English format. The website could be used as the "virtual" prospectus as long as it meets the disclosure requirements of the Federal securities laws.

Although the disclosure documents filed with the SEC are available electronically through EDGAR, the EDGAR system is extremely cumbersome and difficult to use. Other private vendor systems, such as 10-K Wizard, are easier to use. But companies – on their own website - are really best at telling (disclosing) their own story. Therefore, the website should be used as the medium of communicating to shareholders and other investors.

2. **What changes do you think should be given highest priority with the SEC?**

The highest priority should be placed on activities that add value to issuers and investors. Currently, too many talented staff members at the SEC spend all of their valuable time reviewing disclosure documents. The comments their review ultimately yields while helpful at times, frequently add little value in terms of investor understanding, and regularly cause significant delay and expense for issuers. I believe that the focus of the SEC staff should be on interpretive positions, rulemaking and exemptive orders. The SEC staff needs to be spending their time evaluating and interpreting the federal securities laws – initiating change that reflects the markets in which we live – not becoming an impediment. The core values of the SEC staff need to be refocused to add value to our markets and encourage capital formation.

3. **The Commission has issued no-action positions over the years addressing the use of electronic communications for various purposes, including prospectus delivery. Have those positions gone far enough. Why or why not?**

No. I do not believe the SEC has gone far enough. Although the Commission has moved the ball forward on electronic communications, the SEC staff positions have only addressed limited circumstances, such as electronic delivery of prospectuses. As I mentioned, the fact that the SEC does not consider information to be publicly disclosed when it is presented on a company's website seems out of touch with the realities of the millennium. The types of actions that need to be taken by the SEC should be much broader in scope. It is not only the delivery of the information via the Internet that should be the subject of SEC interpretation, but also that the Internet should be recognized as the appropriate medium for disclosing information to the public. If the staff had more time to address these larger issues, both the interests of registrants and investors would be served.

4. **What, in your view, is the utility of the registration process when institutional and retail investors have such a vast amount of information available through providers other than the SEC?**

I believe that the current registration process is antiquated and outdated and causes huge delays in the capital formation process without providing corresponding benefits for investor protection. The problem is that the registration process is based on an outmoded form of communication – the written prospectus. The reality is that public offerings are not sold off prospectuses, or the registration statement of which it is a part. Although the SEC "plain English" initiative improved disclosure, prospectuses are still awkward and remain unread by the vast majority of public investors. The majority of public securities are sold to mutual funds, and fund managers research far beyond the registration statement, ironically using among other principal sources, the registrant's website and the Internet. To further the irony, individual investors use websites and Internet chat boards to get to the real plain English scoop. The disclosure process needs to become much more dynamic, and a "virtual" prospectus using a company's website would be much more effective.

5. **What is the utility of the prospectus? Where do investors get the information on which they rely to make investment decisions?**

In my experience, the prospectus has very little practical utility in today's market place – especially since, as a legal matter, the prospectus is not even required to be provided until *after* the investment decision is made. As discussed earlier, both sophisticated investors and retail investors access the Internet and a company website to get information about an issuer.

6. **In your experience, what is the utility of a 30-day review of a registration statement by a SEC examiner?**

I do not believe there is much value added by the SEC review process which, I would note, ordinarily takes much longer than 30-days to complete. Many times the review process is conducted by an unseasoned examiner. Many times the comments are as insignificant as whether a registrant used "such" or "certain" to often. Very rarely does the comment process provide any real insights.

In addition, because of an extended comment period that may stretch well beyond the 30-days, a registrant may not only incur excessive costs – the registrant may miss a market window altogether thereby foreclosing any opportunity to access the public markets.

7. What steps should the SEC take to make the registration process more efficient and useful to investors?

My belief is that the registration process should be eliminated, and the Federal securities laws should be amended to be principally an enforcement-based system. A registrant, its counsel, underwriters and their counsel should be responsible, and as a practical matter in today's marketplace are responsible, for implementing the disclosure regulations. The SEC should be the "cop on the street," and fulfill its role form an enforcement perspective.

8. Do you believe the Commission has adequately used its broad exemptive authority under the Federal securities laws to reduce regulatory burdens to capital formation? How should the Commission use this authority to achieve that goal?

I do not believe that the Commission has used its broad exemptive authority to reduce regulatory burdens on capital formation. As discussed earlier, the SEC staff has been focused on reviewing outdated registration statements and has not taken a fresh look at the capital formation process. Because its resources are so heavily weighted toward disclosure review, the staff does not have the resources in any meaningful way to address creative ways to encourage capital formation. The staff's time needs to be refocused on activities that add value - - interpreting the law to create opportunities for capital formation.

9. Do you believe that consideration of capital formation in regulatory actions would help or hurt investors? Please explain.

I believe that the initiatives that I have described would help investors. By using the Internet and allowing companies to tell their own story on their own websites, investors would receive meaningful information about the company and would have a better understanding of whether they want to invest in such company. By having a system of disclosure based on documents that investors do not read seems to potentially deprive investors which they need the most - - information. Ultimately, the antifraud provisions of the statute would serve, as they do today, to ensure that companies will seek to avoid misstatements and half-truths.

10. Do you believe the NSMIA standard of consideration of competition, efficiency, and capital formation should be applied by the Sec in their consideration of SRO rules? What would be the impact if the SEC did apply that standard to SRO rules?

I believe that it is crucial for the SEC to use its exemptive authority more frequently. The SEC staff is on the front lines and can react more quickly than Congress. Competition, efficiency and capital formation should be the goals of SEC regulatory action and should be applied in all context.

THE TESTIMONY OF GREG HALPERN, CEO OF CIRCLE GROUP INTERNET, INC., TO THE SUBCOMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE COMMITTEE ON FINANCIAL SERVICES OF THE U.S. HOUSE OF REPRESENTATIVES

June 26, 2001

Madam Chairwoman:

Thank you for inviting me to this hearing. I'm Greg Halpern, founder and CEO of Circle Group Internet, a funding and consulting firm from Mundelein, Illinois. I represent 21 million small business professionals who create half of the jobs in America. They aren't here because today is a workday. If you run a small business, every day is a workday.

My written testimony addresses today's issues in detail. To summarize, small businesses like ours produce more than half of America's private gross domestic product. By 2005 we will create 60 percent of the new jobs in this country. These are figures provided by the United States government. This is not rhetoric. It's reality.

Small businesses struggle to succeed despite often unreasonable or misguided regulations, taxes and little representation. We face regulations that make the raising of capital difficult, if not impossible.

Today's hearings are concerned with the Securities and Exchange Commission. The Great Depression created a need for the S.E.C., and it has served its purpose. Nearly a century later, however, the S.E.C. has failed to keep pace as markets and the global economy have evolved. I'm not here to propose increased limitations of the S.E.C.'s power. Let's help the S.E.C. continue its mission and at the same time assist small business.

Today, the process to register with the S.E.C. is so time consuming, expensive and subjective that many small businesses either drop out during registration or avoid it altogether. The S.E.C. regularly fails to comply with the Act of Congress known as the National Securities Markets Improvement Act of 1996 concerning "competition, efficiency, and capital formation" in the S.E.C.'s rulemaking activities.

Hundreds of companies retired from the S.E.C.'s registration process in 2000. The opportunities missed by just these companies represented billions of dollars that could have gone toward jobs, the economy and tax dollars to the treasury. Was the next Home Depot, Dell or Yahoo among them? We'll never know.

Small businesses register their securities under Regulation SB. The SB stands for small business, and is supposed to be a much simpler and friendlier way to enter the capital markets based on objective criteria. But in reality, SB often predisposes the S.E.C. against the very companies it is supposed to serve.

The S.E.C., often mistakenly loses sight of its simple objective mission of ensuring full disclosure and sending companies off to market. Instead, many companies are drained needlessly of time, money and resources answering endless rounds of questions and waiting for the slow process to resolve itself.

Another issue that affects many small businesses is the Investment Act of 1940, which requires public companies to hold no more than 40 percent of their value in the securities of other companies. This hurts firms like ours, because as we fund other emerging companies, and their securities increase in value, we find ourselves out of compliance. This means, we become victims of our own success.

At the end of the day, this is not about the 40 Act or Regulation SB; it is quite simply about the larger issue of the S.E.C.'s role in capital formation.

The S.E.C. was told in the last century to support capital formation, and it needs to learn how to work with small business in this new century. Small businesses need relief now. The processes are in place. The S.E.C. just needs to let them work.

Additionally, I propose the creation of a department in the S.E.C. to be known as the Small Business Advocacy and Liaison Office. This office should serve small business ventures that require special assistance in reaching the capital markets. It would fall under the Division of Corporation Finance and represent the 19^{th} office in the commission.

The office would advise small businesses how to meet the regulations and requirements of the S.E.C. It would monitor processing of applications and provide quick and reasonable responses.

The office would establish a schedule to better prepare businesses for their S.E.C. experience. The office should respond with clear and concise information regarding any difficulties or irregularities with its constituent applicant companies.

And finally, the Small Business Advocacy and Liaison Office would provide an annual review of the S.E.C.'s rules and regulations related to all small business entities and make recommendations to Congress for changes in those policies that may unfairly encumber small businesses.

I thank you Madam Chairwoman and the rest of the Subcommittee for the opportunity to take a day off and come to Washington and discuss the concerns of 21 million of my fellow small business professionals. I know there is a genuine willingness on your part to help, and together we can solve these problems and get on with the task of building our businesses and the nation as well.

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Subcommittee on Oversight and Investigations

House Committee on Financial Resources

U. S. House of Representatives

Hearing on:

"The SEC's Role in Capital Formation"

Testimony By:

The Honorable Donald J. Devine

Grewcock Chair and Professor, Bellevue University
Former Director, U.S. Office of Personnel Management
Senior Scholar, ACU Task Force on Regulatory Reform

The Need For Oversight of SEC Capital Formation Rulemaking

There is nothing more important to the economic prosperity of the United States than capital formation. It is the engine that feeds the creation of jobs, supplies earners with additional income and accumulates savings for retirement, which provide for the security of the overwhelming number of Americans. Yet, the government agency most responsible for overseeing the capital markets—the federal Securities and Exchange Commission (SEC)--does not take seriously into account the effects of its rulemaking on capital formation when it exercises its powers of regulation. This is a public scandal.

Congress long has been aware of this problem. In 1996, the forerunner to this committee initiated and passed the National Securities Market Improvement Act (NSMIA) that specifically required:

> Whenever pursuant to this title the Commission [SEC] is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[1]

Yet, as this committee has found in the past, the SEC has ignored this provision. On April 17, 2000, both former chairman Tom Bliley and current chairman Michael G. Oxley wrote to then SEC chairman Arthur Levitt an oversight letter requesting information inquiring whether the SEC had followed this section of the law.[2] After receiving the Levitt and staff SEC response in a May 24, 2000 letter, and reviewing it, both the past and current chairman wrote again. This time they concluded that the current SEC practice "does not meet that [NSMIA] standard".[3] Reading the SEC response, one is forced to agree.[4]

Committee Chairman Michael Oxley and Subcommittee Chairman Sue Kelly are to be congratulated for pursuing this critical matter now with a Congressional oversight hearing. The easy way to make headlines is to focus exclusively upon fraud. And, certainly, the prevention and punishment of fraud are important functions. Yet, as will be demonstrated below, the SEC attacks fraud in its rulemaking by "correcting" unrelated, more substantive rules and leaving the fraud rules unchanged, a logical non-sequitur. It has used capital formation rulemaking as a means "to do something" to meet Congressional and investor concerns, without any real effect on the definition or enforcement of fraud. Its only remedy is to increase "disclosure," regardless of cost. As Congress recognized in 1996, this does not make sense. In addition to the important duty of protecting investors, the SEC must also consider efficiency, competition and capital formation if it is to regulate in the full public interest. The most serious example of this mode of thinking occurred in 1999 when the SEC effectively eliminated its most important capital-generating initiative, evaluating capital effects, efficiency and competition only in the most superficial manner in its final decision. Apparently, passing the law and a formal committee finding are not enough to get the attention of the SEC.

This is no academic exercise. At the very time the committee was seeking compliance with the law by the SEC, that agency was pursuing perhaps the most destructive action of its long tenure—eliminating public securities offerings from coverage under Rule 504. The original rule may have had as much effect in creating the nearly two decade boom starting in the early nineteen eighties as any of its more heralded contributing factors. Yet, in 1999, the SEC eliminated this source of capital for small public offerings and within a few months the small capital markets stalled and, later, tanked. It is enormously important that this Committee investigate what happened at that time when the SEC ignored the law--and the committee's warning--so that this destructive economic dislocation never is caused by the government again.

Small Business Is The Prime American Capital Generator

The capital markets for large private sector corporations in the United States are the most efficient imaginable. A public firm that can be listed on the New York Stock Exchange can raise the funds it needs, whatever the level, as long as it can convince investors that its future will be as successful as the present or even better. The secret is their large resources base and current success, reflected in the fact that it qualifies for listing. The same may

[1] National Securities Markets Improvement Act (NSMIA) of 1996, Section 3(f) of the Securities Act and corresponding provisions of the Exchange Act and the Investment Company Act.
[2] House Committee on Commerce Correspondence, April 17, 2000, number 7.
[3] House Committee on Commerce Correspondence, August 2, 2000, p. 2.
[4] House Committee on Commerce Correspondence file, SEC Memorandum dated May 24, 2000, number 7, p.7.

be said of the NASDAQ national and small capital markets. The situation is not as favorable for the millions of small firms that are forced to rely upon the NASDAQ Over The Counter (OTC) Bulletin Board, the private National Quotation Bureau's "pink sheet" markets, or private funds raised from friends, relatives and neighbors.

While small business has the most difficulty in raising capital, it is clear that small business also is the most dynamic part of the business market. It creates the overwhelming number of new jobs and it is the source of much of the innovation that makes the U.S. business sector so dynamic. As shown in Table 1, a bit more than half of all employees work for firms with fewer than 500 employees. Equally important, these firms produce 47 percent,

Table 1. Importance of Small Business

Firm Size	Employees (1995)	Receipts (1995)	Net New Jobs (1992-1996)
Under 500 employees	52,653,000	$ 7.4 billion	11,827,000
Over 500 employees	47,662,000	$ 8.3 billion	- 645,000

Source: Small Business Administration, Small Business Answer Card, 1998, pp. 1,3.

or almost half, of the business receipts of all firms. The most interesting statistic, however, is their affect on new job growth. As noted, firms of over 500 employees actually had a net decrease in jobs over the period of 1992 to 1996. If all of America were large firms, employment would look like that of Europe, stagnant. But the greater number of small firms in the U.S. has been the source of its greater dynamism. Firms of under 500 employees have created all of the net new jobs during the boom years. Indeed, most of the jobs were created by firms of five or fewer employees.

Surprisingly, most of the funds are raised privately from friends or on private credit sources.[5] About 75 percent of small firms seek credit, mostly from traditional or commercial loans or from personal or business credit cards.[6] But those firms that wish to grow more substantially generally must ultimately raise funds publicly. It is just not possible to grow very large without raising funds in the securities markets. And there one comes into contact with the government regulation of securities and exchanges.

The Securities and Exchange Commission Regulatory Structure

Securities have been regulated in the United States since 1933. The Securities Act of that year required that companies give investors "full disclosure" of all "material facts" that investors would need to make an investment decision, to register investor information with the SEC, which declares the investment "effective" (but not safe or good) if they satisfy its disclosure rules. The Exchange Act of 1934 required public companies to disclose information about their business operations, financial activities and management to the SEC and, in some cases, to investors.[7] Over the years, filing and information production requirements have grown more complex and more expensive. It is virtually impossible for the average small businessman to keep up with requirements. Indeed, the SEC itself recommends the use of an attorney to avoid possible penalties.[8]

In an effort to help small businesses without great staff support, the SEC opened a Small Business Office in 1979 to provide assistance.[9] Yet, it was forced to deal with the existing, complex process and could only assist at the margins. By then, the basic filing form had become very complex indeed. Basic Form S-1 became infamous for its difficulty, cost and density--frustrating the openness originally sought by the acts. A form SB-1 was added to allow transaction under $10 million by small (less than $25 million in revenues and stock worth no more than $25 million) firms in a simpler question and answer format. SB-2 followed for any size transaction with specific criteria in plain language to be followed. They helped a bit but still require professional assistance. Other forms were equally complex. The lack of clear guidance causes innocent error that can lead to administrative or legal problems.[10]

[5] Steven Moore and John Silvia, "The ABCs of the Capital Gains Tax," Cato Policy Analysis, October 4, 1995, pp. 29-30.
[6] "Small Business Answer Card, " Small Business Administration, 1998, p.1; FAQ Card 2001, p. 2.
[7] "Small Business and the SEC," Securities and Exchange Commission, 2000, pp. 1-2
[8] Ibid., p. 2.
[9] Testimony of Brian Lane, Director of Corporate Finance, before the Subcommittee on Government Programs, House Committee on Small Business, October 14, 1999, p. 1.
[10] "Small Business and the SEC," pp. 5-6.

In response to public and business complaints, both the SEC and Congress have, over the years, provided some exemptions from the more onerous requirements, although even these are properly subject to the anti-fraud provisions of the law. There is an interstate exemption for transactions within a state (Section 3(a)(11)), although it is almost impossible to meet since if even one share is offered or resold out-of-state the exemption can be lost. Private offerings are exempted under Section 4(2) but the purchaser must be a "sophisticated investor" and no advertising or public solicitation may be used. Significantly, even the SEC admits that the precise limits of a non-public offering are "uncertain." Section 3(b) authorized the SEC to exempt small securities offerings and this led to a Regulation A affecting offerings of $5 million or less in a 12-month period. These do not need to be audited. Still, the company must file an offering statement with the SEC for review and a statement similar to the traditional prospectus must be given to investors.[11] The review process is long--often several months, during which time conditions change--and expensive with lawyers, accountants, consultants and the rest.

Regulation D offers some other alternatives. Its Rule 505 offers an exemption for offers and sales up to $5 million in 12 months to any number of investors--but they must be "accredited" (except for 35 other persons), i.e. sophisticated and registered, and the instruments are "restricted, i.e. they " cannot be resold for at least a year without registration. Financial statements must be made available and certified. Rule 506 is a "safe harbor" for the private offering exemption. It at least provides some protection from arbitrary prosecution by spelling out (to some degree) what information is needed (although the SEC will not give absolute assurance against future prosecution).. There is also a general accredited investor exemption (Section 4(6)), for sales for employee benefits (Rule 701), and qualified purchasers in California (Rule 1001).[12] But the only generally useful exemption was Rule 504.

The Reagan Small Public Company Reforms of Rule 504

Inspired by the overwhelming victory of President Ronald Reagan in 1980 and the renewed interest in entrepreneurship and growth this generated around the world, the SEC adopted a major capital formation reform on April 15, 1982. Rule 504 was specifically adopted to allow small businesses to more easily raise capital without the red tape and cost usually associated with SEC offering rules. Small business was recognized as the growth-generator and the need to liberate it from excessive red tape seemed manifest.

Rule 504 allowed private and public stock offerings of up to $500,000 (later raised to $1 million) to be sold within 12 months to an unlimited number of investors without a prospectus and without regard for the investors' "sophistication," accreditation, or amount of knowledge, as long as the offering was filed under state law. These so-called blue sky laws generally required a disclosure document but with less information and fewer costly administrative hurdles.[13] Approval was possible within 30 days (rather than months) by most states at a modest cost. Section 504 immediately became the offering tool of choice among small public and private stock offerings. It unquestionably, became one of the engines for the growth of the stock market, especially, internet and technology stocks and the prosperity that they inspired and led.

Rule 504 was further liberalized in July of 1992. All federal restrictions other than fraud were removed and all offerings under the rule offerings were subject only to state regulations. General solicitations and advertising were allowed and offerings were not "restricted" for resale by non-affiliates of the issuer.[14] Whatever slowdown there was in 1991 quickly turned to furious growth, especially in the small public company area that relied upon these 504 liberalizations to raise the capital necessary for their growth and that of the economy generally.

The Penny Stock Reform Act of 1990

Beginning in 1988, Congress began hearings into complaints of fraud and abuse in the "penny" or "pink sheet" or "gray market" organized by the private National Quotation Board. These resulted in a 1988 law that generally defined penny stock and required additional disclosures. Later SEC rules defined "penny" stock as a security that sold for less than $5 per share and was not listed or authorized for quotation on a NASDAQ market exchange. A risk disclosure document, a disclosure of bid-offer quotations, the compensation of the broker-dealer and a monthly value of stock held were required from broker-dealers, although certain securities were exempted.

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[11] Ibid., pp. 10-12.
[12] Ibid., pp. 10-15.
[13] Final Rule, 17 CFR 230, Revision of Rule 504, 2/26/99, p. 6.
[14] Ibid., p. 7.

Two things were clear from the 1990 hearings and findings: Rule 504 offerings were not implicated and only disclosure rather than changes in the fraud rules themselves was offered as the solution. Indeed, the major study of the changes by two professors from the University of California concluded: "While apparently significant, these rules added little to existing SEC and NASDAQ rules and practices designed to prevent securities fraud in the penny stock market."[15] As a matter of fact, the basic SEC fraud and abuse rules have remained rather constant since the original securities act. They are sufficient to the task of fraud prosecution, as SEC enforcement actions testify.

The Concern With "Microcap" Fraud

No good deed goes unpunished and deregulation of the small capital market was no exception. While recognizing that the Rule 504 reforms generally operated effectively and fairly, but with the large growth in these markets, the SEC, with only spotty anecdotal evidence, began in 1997 to be concerned with exploitation of the Rule 504 exemption. In a few cases, the lack of state regulation in New York was used by dealers resident there to avoid any regulation at all. In some cases, securities were placed with dealers who used cold-calling to sell securities at ever-increasing prices to unknowing investors. Worse, when the inventory of shares was exhausted, the principals sometimes allowed the artificial demand to collapse, selling short or taking paper loses to offset gains, with investors losing their investment, in a scheme called "pump and dump." The SEC initially believed that the fraud was limited to sales in the secondary, i.e. resale, market.[16]

The SEC originally proposed to close the New York "loophole" and to restrict all re-sales for a period of one year. Objections from dealers and others, however, led it to do the former but instead of the latter limited Rule 504 to private offerings only--which it claimed were the vast majority of 504 transactions anyway--plus state regulation.[17] But this left public offerings without the 504 flexibilities and this low-cost means to raise capital. On top of this, NASD, which also has regulatory authority, ruled--with SEC approval--that only SEC-reporting companies could now have access to its exchanges, including the OTC Bulletin Board.[18] The OTC was used by many of the small public companies utilizing 504 without having to report to the SEC. At the same time, NASDAQ and the other exchanges raised the standards for registering with each of the hierarchy of exchanges. In addition, the SEC was considering a rule to require not only the market-maker to do due diligence on a stock offering but for all additional sellers to do so too. Objections from brokers and SEC commissioner Norman Johnson have held up this regulation but it still causes concern in unsettling markets nonetheless.[19]

The requirements for listing were increased substantially. Small firms do not come close to qualifying for The New York Stock Exchange so their only real choices are NASDAQ or OTC. The requirements for their major markets are listed in Table 2. The assets required for initial listing are substantial and, for continued listing, they are even higher. More importantly, the income requirements were raised substantially from the old listing before the regulatory change to the new ones that now apply. For the NASDAQ National Market, the asset requirement was increased 50 percent. The newer SmallCap Market began at the old National level and almost doubled the net revenue requirements. These higher requirements (and the SEC approval processing) caused the greatest burden and the requirements still provide a barrier to entry today.

Table2. Requirements for Access to Capital Market Exchanges (initial listing, pre and post "reform")

	Assets	Float Value	Income/Revenue
NASDAQ National Market, old	$4million	$1 million	$400,000 (net)
, new	$6 million	$8 million	$75 million
NASDAQ SmallCap Market, old	$4 million	$1 million	$400,000 (net)
, new	$4 million	$5 million	$750,000 (net)

Source: The Nasdaq Stock Market, Inc. Listing Qualifications (undated).

[15] Jonathan H. Sive and Michael D. Ames, "How to Narrow the Small Business Equity Capital Gap," Small Business Institute Directors' Association Meeting (San Diego: February, 1996), p. 7.
[16] Final Rule., p. 7.
[17] Ibid., pp. 8-9.
[18] "NASD Requests Comments on Limiting Quotations On the OTC Bulletin Board To Securities of Reporting Issuers, OTC Bulletin Board News Release, March 20, 1998; "NASD Announces SEC Approval of OTC Bulletin Board Eligibility Rule, " OTC Bulletin Board News Release, January 6, 1999.
[19] Judith Burns "SEC Push to Combat Microcap Stock Fraud Hits Roadblock," Dow Jones Business News, 9/13/99.

The SEC Cost and Regulatory Analysis in Final Rule 504

The Final Rule Cost-Benefit section does state that the SEC has concluded that its amendments to Rule 504 "will not result in significant adverse effects on efficiency, competition or capital formation." However, as the Committee noted previously the SEC relied mostly on outside sources for data.[20] It justified the absence of data in its analysis by noting that no outside source "had provided data on the plan we adopt today."[21] Since no one knew what plan would be adopted (specifically, excluding public offerings), it did not explain how anyone could have done so. The SEC simply asserted that "those who rely upon the rule will not have significantly increased costs," without data and, more importantly, altogether ignoring the fact that the largest effect was to deny reliance upon the rule for all public offerings. Even for private offerings, it admitted they will be "affected" but did not estimate the costs.[22]

The only specific cost mentioned by the SEC was an estimated $30,000 for preparing and filing Form U-7. GAO reported a NASDAQ estimate of the following fees for an initial public offering of $25 million: SEC registration $9,914, NASD filing fee $3,375, NASDAQ entry listing fees $63,725, NASDAQ annual fees $11,960 and state filing fees $15,000; or $104,024--perhaps close enough for government work. Yet, the SEC itself recommends using lawyers and accountants, which cost the following: accounting fees and expenses $160,000, legal fees and expenses $200,000, and transfer agent and registrar fees $5,000; or $365,000 more. In other words, a potential expense up to $439,000 (although not all would apply at this level in every case) was not considered--and this did not include the largest expense, the underwriting fee of $1.7 million, to say nothing of the loss of a capital market altogether.[23]

The SEC rule is most disingenuous in stating that, "Overall, the rule will maintain the benefits that allow small companies to raise 'seed capital' with a minimal federal compliance scheme for public offerings."[24] Since the new rule eliminated public offerings from Rule 504 coverage altogether, this is a very misleading statement. Together with the OTC requirement to register with the SEC (much more expensive than with the states)--which the SEC had just approved one month before this Rule--it is profoundly misleading indeed. It may rest on the meaning of "federal," by excluding the OTC requirements. It is difficult to believe such an artful statement by a private securities firm would not be considered fraudulent by the SEC enforcement division.

Given the cavalier manner in which this cost-benefit analysis was performed, it is not unreasonable to conclude that the SEC, in fact, ignored the NSMIA requirements. At the least, the costs and economic effects were grossly underestimated and the major change of eliminating public 504 capital formation offerings was simply ignored.

The SEC Kills the Boom

The result of these changes was that efficient, low cost, public Rule 504 capital offerings were denied to all companies and 2,982 firms were thrown off the OTC Bulletin Board into the more turbulent pink sheet market or worse, into bankruptcy.[25] This pink sheet market is the same one that during the penny stock scandal was reputed to have a fraud rate of 20 percent.[26] This rash action was taken even as the SEC acknowledged that the original "scope of the abuse is small" even in the 504 secondary market.[27] *In other words, the SEC remedy was to throw the overwhelming number of firms that were not engaging in fraud into a less regulated market where they were more subject to fraud.* It is understandable that the private OTCBB would desire to have its own market as free from abuse as possible and to wantonly cast out the good (but poorly capitalized) firms with the bad. The supposed rationale for the very existence of the SEC, however, is to look at the larger public good and be concerned with all firms, perhaps especially the weaker companies (but ones with future potential).

The SEC even made matters worse. The OTC required that any firm desiring to be listed by it had to first be a reporting firm with the SEC. But the SEC, by law, must approve OTC actions. *At the very least, the SEC--on*

[20] House Commerce Committee Correspondence, August 2, 2000
[21] Final Rule, p. 9
[22] Ibid.
[23] "Small Business Efforts to Facilitate Equity Capital Formation," Report to Chairman, Committee on Small Business, U.S. Senate, (Washington, D.C. : General Accounting Office, September 2000), p. 23
[24] Final Rule, p. 10.
[25] "Eligibility Rule Phase-in Complete," OTC Bulletin Board News Release, June 28, 2000.
[26] Sive and Ames, p. 6.
[27] Proposed Rule 17 CFR 230, 5/21/98, p.2.

efficiency grounds--should have revised the OTC rule to allow time for the early-reporting firms to prepare for reporting, or limited the Form 10 requirements its staff could impose, or delayed the OTC rule until the SEC itself would have been able to process the new application on a timely basis. The listing requirement by a date certain and the necessity for SEC approval was the main reason small public firms were forced off the OTC Bulletin Board market. Many could not meet the high costs for qualifying for reporting status even though they were solvent; but the real problem was, with the large number of companies required to file, the SEC approval process choked from the new paperwork and new requirements imposed by staff. So, even firms that could comply were delayed. In the raucous chase for capital, time is essential and many firms were driven out of business when they could not raise timely capital because they still had not received SEC approval. This created a liquidity crisis that pushed many into insolvency.

Figure 1 shows that the stock market boomed after the SEC adopted the original Rule 504. Market analyst Laurence Kudlow (while making an unrelated point) places the time of the fall of the NASDAQ high tech market as March 2000.[28] Figure 2 documents the disruptive effect of the SEC Rule 504 and OTC decisions on the small cap market. Before the SEC action, the market remained upon its upward course. Following the April 7, 1999 effective date for the amended Rule 504, the small cap market dropped like a stone. For the one-year plus period of the SEC-OTC eligibility process, the market was remarkably unstable. After OTC closed its eligibility process on June 28, 2000, the small cap market dropped even more precipitously. *These data are a remarkable confirmation of the negative effects of the SEC rulemaking on small firm capital formation.*

The OTC data are also illuminating. As Figure 3 shows, the number of positions (priced or unpriced quotes by a specific market maker in a specific OTCBB security) peaked in 1999 before the registration fiasco. The number of deals rather than the total dollar amount is the more important data for small firms that place small dollar offerings. They do not show up in the big dollar totals. As shown, the year 2000 had fewer offerings than either 1999 or 1998. The 1999 high was not reached again until April 2001 and the small public capital markets have still not fully recovered today. The year 2000 dollar NASDAQ Small Cap volume was less than half what it was the year 1999 and the 2001 figures are still well below the high.[29]

Why Were Capital Markets Harmed By the SEC?

It is clear that the SEC views itself exclusively as a fraud cop. That is why Congress was forced to pass a law that required it also to consider other major factors. All of SECs publications and its web site emphasize its single-minded role in protecting the investor. Clearly, this is a very important function. But its powers—even before NSMIA—went well beyond fraud protection. It has regulated securities and exchanges in a myriad of ways. Yet, its only self-perceived function other than direct regulation of fraud through warnings and enforcement has been to provide information to protect investors from future fraud--providing "transparency" through disclosure. But these decisions affect capital formation, efficiency and competitiveness. The Committee correctly concluded that the SEC had been insensitive to the costs it imposed through it disclosure and other requirements. That is why the Committee sponsored the NSMIA requirements to also consider efficiency, competition and capital formation. For some reason, probably bureaucratic resistance to new ideas, the SEC has been unable to adjust to the law. It continues to focus exclusively on fraud prevention and provides superficial cost benefit analysis at best.

SEC's focus upon fraud is so narrow that it leads to misunderstanding fraud itself. The 504 rule change was no exception. The SEC Proposed Rule reported that "initial Rule 504 sales have not necessarily been fraudulent." Still, it was concerned that the rule's "flexibility" could lead to abuse in subsequent (secondary market) sales. Yet, by the Final Rule, the SEC had discovered "recent disturbing developments in the secondary markets and, to a lesser degree, in the initial Rule 504 issuances themselves."[30] It then mentioned three examples of the types of fraud perpetrated--making offerings in states without registration, broker cold-calling, and pump and dump market manipulation.

The SECs illogic is mind-numbing. First, the SEC itself says: "Rule 504 is the limited offering exemption."[31] That is, secondary sales are not 504 sales by its own definition. So, the remedy to the "major degree" problem should not be to Rule 504 at all but to secondary market rules, which the SEC declined to modify in the

[28] Lawrence Kudlow, "Supercharged Signals," The Washington Times, June 17, 2001, p.
[29] NASDAQ Market Data, nasdaq.com.
[30] Final Rule, p. 3.
[31] Ibid., p. 2

final rule.[32] Second, as far as the newly-discovered allegation of a "lesser degree" problem in initial offerings, it is unlikely they exist at all, even under SEC's narrow view. The two cases cited by the SEC in the Final Rule do not, in fact, make the case. The Millennium Software case involved a private offering, not a public offering that was eliminated by the SEC rule—the case is about fraud, pure and simple and not about any Rule 504 provisions. [33] The Spacedev/Benson case involved false and misleading statements in press releases, a newsletter and the Internet—again, nothing to do with Rule 504 exemptions per se.[34]

Third, the problem that some states did not have any regulations was solved by requiring them to have them—but, again, this had nothing to do with Rule 504 itself but only closed a state loophole. While state rules varied widely, most had reasonable disclosure. Fourth, The cold-calling and pump-and-dump examples were the same ones used to justify the penny stock regulations; but we must concur with the University of California professors that the basic fraud rules were sufficient and did not require change to solve these problems. Enforcement, not rules changes, is the reasonable remedy. Finally, the SEC solution was to deny use of 504 for all public offerings. What does this remedy have to do with the purported problem? In sum, the SEC attacked a general fraud problem for which it has had regulatory authority for generations by eliminating an investment method that had benefited small public companies and the economy generally without considering those effects at all in the Final Rule!

It is this SEC culture of myopic focus upon fraud alone that led to the NSMIA reforms adopted by this Committee. It is hard to fathom that the Final Rule change for Rule 504 was published TWO DAYS after the chairman of the predecessor committee reminded the SEC that it should consider the NSMIA changes in any rules it adopted, and that oversight hearings would be held "to ensure that final rules are consistent" with it.[35] It is essential for the sake of logic and economic rationality that the SEC be required to take a broader view of what it does in a rulemaking process that so greatly affects how markets perform. It also happens to be the law.

Reforming the SEC: What Needs To Be Done

There is no question that many good companies were harmed by the SEC rulemaking and implementation and by the related OTCBB requirements. Yet, there is still broad public support for access to capital for small public companies. Small public companies are the future giants that produce new jobs and wealth. There is a serious question whether giants like Microsoft or Home Depot, both of which started as private and then moved to small public company status, could have sold their second or third products or opened their second stores without access to the OTC Bulletin Board Small Cap exchange. Under today's requirements, they would have not met the minimal levels and could have failed, with all of the loss of wealth, service and jobs that would have entailed. Some future producer of wealth and jobs will be deterred by these higher requirements.[36]

The whole idea of chasing the small public companies off the OTC exchange for not meeting arbitrary filing requirements must be questioned. The SEC itself recognized that only a few bad apples were causing the fraud. Yet, 3,000 firms were destroyed and many more harmed in the attempt to get a few. The pink sheet market is just too difficult for any but the most sophisticated to utilize. Anyone truly concerned about fraud would not force a single firm into the gray market, much less three thousand. The small public companies that previously had access to Rule 504 need some relief. The answer is to return to the Reagan reforms in a manner that will also minimize fraud.

This is what needs to be done:

1) Make the SEC Obey the Law: Consider Efficiency, Competitiveness and Capital Formation. This committee is to be congratulated for creating a well-rounded agenda for the SEC with the 1996 NSMIA reforms. It is clear from the SEC response of May 24, 2000 to the predecessor committee and its actions in amending Rule 504 that it either does not or cannot understand its new mission under the law. The 1996 act is not even mentioned as a legal authority for the SEC divisions on its web site. Congress must make the SEC follow the law. The future health of essential capital markets demands it.

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[32] Ibid., p. 6.
[33] SEC v Millennium Software Solutions and Mark Shkolir 97 civ. 9019 S.D.N.Y..
[34] SEC Administrative Hearings Against Spacedev, Inc. and James W. Benson, File No. 3-9668, settlement and cease and desist order, August 6, 1998.
[35] House Committee on Commerce Oversight Plan, February 17, 1999.
[36] Barry Henderson, "A microcap fund thrives by focusing on companies with strong managers," Barron's, 4/3/00, p. F8.

2) Make the SEC Recognize that Disclosure Has Costs. At some point, paper disclosure requirements have rapidly demising returns. Disclosure, in any event, does not equal fraud reduction. Fraud is a long-established legal norm at the SEC and can be fully prosecuted under present law. Using examples of pump and dump and cold calling to require burdensome disclosure requirements is not a logical relation of means to ends. All the disclosure requirements in the world will not stop determined crooks. These acts are already forbidden and predators will not be stopped by a few more barriers. As far as can be ascertained, there were no cases of fraud directly related to the Rule 504 exclusions from SEC requirements, in any event. State regulation and general SEC fraud protection seemed to be sufficient and, in fact, were working to create enormous wealth before the SEC eliminated them and disrupted the market.

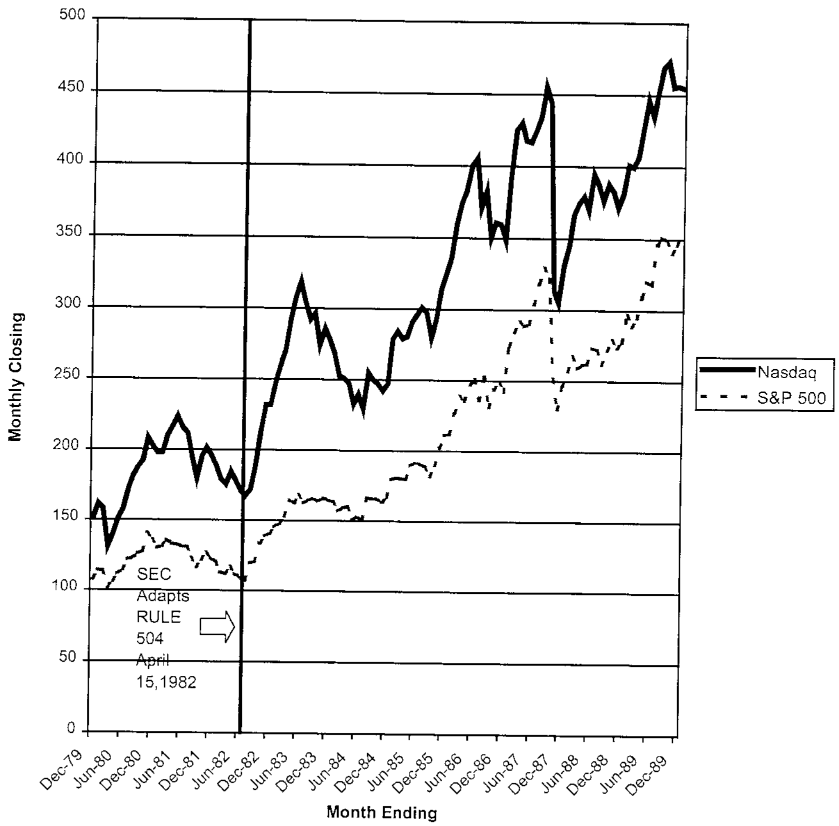
3) Apply NSMIA to SEC Approvals of NASDAQ and OTC Regulatory Approvals. The facts of the 504 changes reported here make it clear that SEC approval of private market regulations is as important as SEC rules themselves. The new NASDAQ standards for access to the various exchanges were set arbitrarily, and high. The OTC process eliminated 3,000 firms, one or more of which might have survived to fuel a future recovery and create new jobs. Congress should review these requirements and require the SEC to consider the NSMIA criteria in approving private exchange rules too.

4) Give Stockholders More Control of Fraud. The real way to control pump and dump fraud is to require that existing stockholders approve issuance of stock, for they have the necessary interest not to dilute its value. The worst fraud occurs when an owner and small board of directors dilutes the stock while protecting themselves or even gaining in the transaction. The solution is to put stockholders in charge, not remote bureaucrats. Any board or chief executive decision that would have the affect of diluting outstanding stock by 20 percent or more, or equaled 10 percent of a public float, should require stockholder notice and approval. Stockholders should be in control of their firms in any event.

5) Create a New Rule 504 for Public Offerings for Small Business and Raise Transaction Level to $5 Million. Since all small businesses that have survived the SEC transition and now report, all existing small caps already have the higher standards requested by the regulators. All that must be accomplished now to restore the Reagan reforms is to allow small public companies to raise funds within 12 months from an unlimited number of investors, without a prospectus, and without regard to the investors' sophistication (or, at a minimum, at least substantially expand the number of accredited investors). Small public companies need the flexibilities and lower costs of 504 exclusions from excessive reporting--and there are no examples raised by the SEC of abuses that relate directly to Rule 504 initial offerings. The amount of allowable transactions, however, should be raised to $5 million in any one year for all 504 firms, reflecting this good experience and the possibility to increase capital formation enough to restore the earlier prosperity.

BY: Dr. Donald J. Devine, Grewcock Professor at Bellevue University, a senior scholar and vice chairman at the American Conservative Union, adjunct scholar at The Heritage Foundation, and columnist at The Washington Times, is the former director of the U.S. Office of Personnel Management and former professor of government and politics at the University of Maryland. In accordance with committee procedures, he acknowledges that he has not been a recipient of federal grants or contracts in the past two years. He acknowledges the assistance of Stephen Thayer, Meredith Gray and, especially, Brent Stoddard.

FIGURE 1
Nasdaq Composite and S&P 500
1979-1989



Sources:Nasdaq and Standards and Poors

FIGURE 2
Small Cap Price Per Share 1998-2001

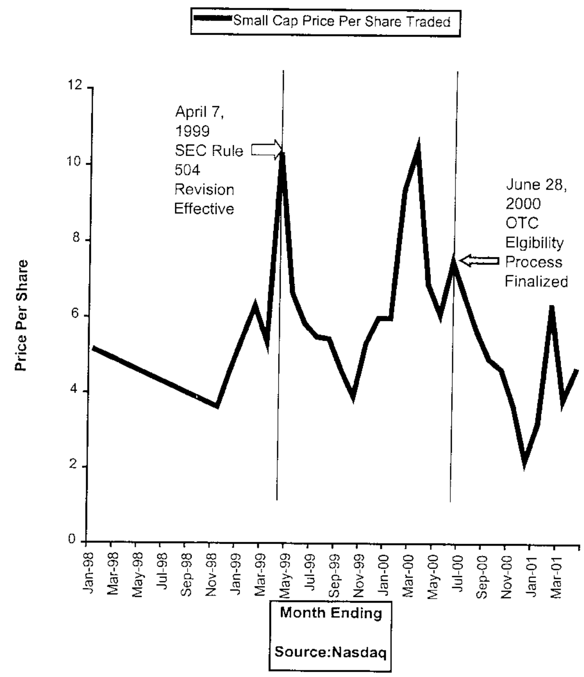
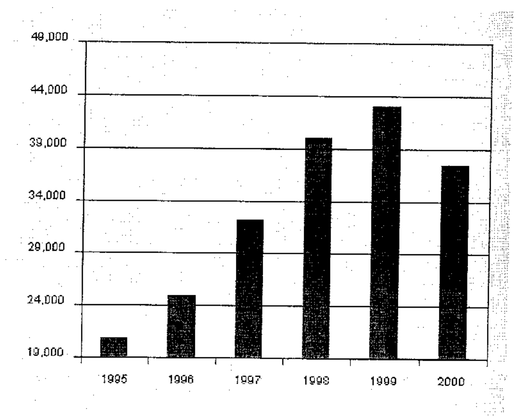


FIGURE 3
Number of OTC Positions
Priced or unpriced quotes by a specific market maker in a specific OTCBB security



Source:OTCBB

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July 12, 2001

The Honorable Sue Kelly
Chairman
Subcommittee on Investigations
House Committee on Financial Services
2129 Rayburn HOB
Washington, DC 20115

Dear Congresswoman Kelly:

Again, thank you for holding the oversight hearings on the SEC. I was pleased to hear that you will follow with testimony from SEC itself. As I mentioned in my testimony, this is essential if SEC is to ever follow the law, especially on capital formation.

My responses to your follow-up questions are listed below.

1. There is no reason that the Internet could not be used for any proper, non-fraudulent activity in the raising of capital or for whatever filing may be required. It should be legal for anything that is legal for paper, telephone or word of mouth. It is just a modern version of these traditional methods.

2. The highest priority for the SEC is to change a bureaucratic culture that conceives every capital transaction as a potential fraud. If everyone is viewed as a potential criminal, the normal response is to make it as difficult as possible to transact business. In general, this has been the SEC's method of operation, with some positive exceptions--among them the original Rule 504 "exemptions" (note the term implies that free trading [under state rules] is exceptional and regulation and restraint are normal). In general, regulatory burdens should be lightened, stockholders should be given more power to control fraud, and the SEC should concentrate on policing the serious scam artists. The original Rule 504 should be the guide, not the recent restrictions.

3. It is still not practical to do enough over the Internet. The SEC needs to seriously listen to the private sector and open up its procedures.

4. The registration process produces paper rather than real information. Naïve investors do not seek this information out and sophisticated ones do not need to rely upon it since they have much better information from other sources.

5. No one reads a prospectus except the SEC (sometimes) and even this does not normally lead to action beyond superfluous information never relied upon by a single investor. Investors get their information from brokers they trust, investment advisors or research on their own. All of these have access

to mountains of data that supply them with the information they need for a decision. Private exchanges provide the necessary protections, although these are often pushed in the direction of SEC over-regulation since they must receive SEC approval for changes.

6. It is unnecessary and it generally takes much longer.

7. If registration is retained, it should not require SEC affirmative approval but should be automatic after 30 days when it should be available for public scrutiny.

8. Rather than reduce regulatory burdens since the passage of the 1996 Act, the example of the Rule 504 changes in 1999 show the SEC is moving in the opposite direction. The Commission should review its own thinking and philosophy on Rule 504 during the 1981 to 1992 period as a model for reform generally.

9. Again, the SEC has a policeman mentality. Everyone is a potential criminal. This makes sense in the enforcement division (although, even there, a sense of fairness would be helpful) but not in rulemaking. That is why the 1996 Act restricted consideration of capital formation to rulemaking. These are two very different functions and need different outlooks. From a personnel perspective, perhaps there should be less transfer of ideas and personnel between the functions at the SEC. There is no question that investors would be helped by a better-functioning capital market, for a rising tide does lift all boats. For the problems, there is always the enforcement division.

10. Unless SRO approvals are included, much of the actual regulation is missed. In the 1999 Rule 504 situation for small public firms, it actually was the NASD through its OTCBB that took the major regulatory action. In approving what for the OTCBB itself in a narrow sense might have been a rational decision, the SEC did not take into account that many firms would be chased into the more chaotic pink sheet market. If the SEC had internalized the 1996 standards, it would have taken a different approach and may well have avoided the disaster of 3,000 firms being delisted and the capital market for small public firms so destabilized.

I have also included a corrected copy of the transcript. Again, congratulations on holding the hearing and we look forward to working with you as you proceed.

Sincerely,

Dr. Donald J. Devine

PREPARED STATEMENT OF:

JAMES A. STEINKIRCHNER

CO-CHAIRMAN

NATIONAL SMALL PUBLIC COMPANY LEADERSHIP COUNCIL

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BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE

OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE

9:30AM 2128 RAYBURN HOUSE OFFICE BUILDING

JUNE 26, 2001

CONGRESSIONAL TESTIMONY ON SMALL BUSINESS CAPITAL FORMATION

I am testifying today as the Co-Chairman of the National Small Public Company Leadership Council. The Leadership Council, based in Washington, DC, seeks to educate and inform members of congress about the economic contributions of small emerging growth companies.

The Leadership Council is committed to assisting small business, both public and private, in capital formation issues. Our initial goal was to provide a forum for small-cap public companies seeking regulatory relief, we have since expanded our focus to address the overall concerns for all small business owners. The Leadership Council has represented the interests of small business to the securities regulators who govern our industry and the policy makers in Washington, DC. The Leadership Council now holds regularly scheduled meetings where small public company's, small business owners, venture capitalists and members of the investment banking community exchange ideas, voice opinions on pending legislation and become educated on matters affecting our industry. As our organization grows, we hope to enhance our contribution to regulatory and legislative matters.

INTRODUCTION

While the largest public company's, banks and brokerage firms have lobbied the Securities and Exchange Commission (SEC) to adopt new laws and regulations. The small business owners of this country have basically been ignored. The eighteen (18) year economic boom has over shadowed the concerns of small businesses, which were the biggest driver of new jobs in our country. Regulators and Politicians have either ignored the concerns of small business or in many cases not aware of the problems small businesses face. In the process, they are potentially threatening the longest economic expansion in our country's history. The Leadership Council urges that any new laws and regulations consider its impact on the small business marketplace. The Leadership Council believes that ignoring the issues that face small business could jeopardize our economy.

A SHORT HISTORY OF MARKET CHANGE

The evolution of our securities markets can be characterized as having three distinctive phases of its development; creation, regulation and deregulation.

The creation of our financial markets started with the Buttonwood Agreement in May 1792 (named for a tree at 68 Wall Street under which they traded) and ended with the crash of 1929. During this era we saw the creation of The New York Stock Exchange, The Stock Ticker, Gold Rush of 1849, Robber Barons and WWI.

The regulation phase of our financial markets started with the crash of 1929 and ended May 1, 1975 ("May Day") when the Securities and Exchange Commission (SEC) eliminated the fixed commissions brokers were charging for all securities transactions. During this era we saw the creation of the Securities and Exchange Commission (SEC), the adoption of the Securities Exchange Act of 1934 (Exchange Act), Investment Company Act of 1940 (Investment Advisors Act), National Association of Securities Dealers (NASD) and WWII.

The deregulation phase of our financial markets started with "May Day" 1975 and is ongoing.

Since 1975 we have seen the fall of Glass Steagall, The National Securities Markets Improvement Act (NSMIA) signed into law, the creation of the Internet, end of The Cold War, creation of the National Market System, creation of the P.C. and the crash of 1987.

As we enter into the next phase of our securities markets, globalization, many changes need to be made. First and foremost is the modernization of our securities laws. In 1998, the most significant initiative undertaken by the SEC since the 1933 "Securities Act" and the 1934 "Exchange Act" were signed into law. Dubbed "The Aircraft Carrier", due to its enormous size, would modernize the securities markets and overhaul the 1933 and 1934 acts. Although, I doubt the "Aircraft Carrier" would be passed into law in its current state, certain segments can be implemented and some already have.

OVERVIEW OF SMALL BUSINESS

The dramatic expansion of our economy in the 1980's and 1990's was that entrepreneurship flourished, due mainly to large firms downsizing and reorganizing. Small business owners with some great new ideas became the leaders of our "New Economy". Company's like Home Depot, Intel, Microsoft, Oracle, Wal-Mart and Cisco Systems have created more economic wealth then anytime in our history. What people forget to remember is that all these company's were small businesses with a good idea. All of these company's struggled during their inception with: capital, laws, regulations, hiring qualified employees and employee benefits. They virtually clawed their way to the top. Remember this was the era of big business and still is. Our goal is to help small businesses lower these impediments and create an even greater economic boom.

Now is the time for small businesses to be heard. For the last 200 years congress has focused on big business. The laws and regulations passed over the last two century's were result of the size, power, capital and lobbying that big business had on our economy.

The results of small business on the economy speak for themselves, according to the SBA office of Advocacy Findings:

- small business with fewer than 500 workers employ 53% of the private non farm work force
- contribute 47% of all sales in the country
- responsible for 51% of the private gross domestic product
- over the 1990-1995 period, small firms with fewer than 500 employees created 76% of net new jobs
- 60% of new firms begin at home
- number of business tax returns filed in the U.S. has increased 73% since 1982 to 24.8 million in 1998 - more than 99% were filed by firms defined as small under size standards set by the SBA
- about 21 million Americans - 17% of all U.S. non-agricultural workers - are engaged in some entrepreneurial activity
- micro-business with 1-4 employees generated 60.2% of the net new jobs over 1994-1998

Small business now controls the power and size of our economy and the SBA's numbers prove this. What they lack are capital and lobbying, both of which are being addressed today.

The Leadership Council believes greater access to the capital markets is needed to fund the growth engine of our economy, which is small business. I am proposing ten (10) initiatives to help both small public and private company's compete in our global economy. It is the job of congress to recognize the issues relevant to small business and when creating new laws and regulations to take into account the economic impact of these actions.

SMALL BUSINESS CAPITAL FORMATION

The life blood of any business is capital. It gives businesses the ability to grow and sustain economic or industry downturns. Although, the Government has created an efficient market mechanism to raise capital, it still needs tinkering from time to time. With the dramatic growth of small business in our country we need a more efficient way to raise needed capital. The current laws and regulations, which allow companies to raise capital, were created in the early 1930's and have been periodically amended. The problem with many of these laws is they were created with large company's in mind, they do not take into account the cost-benefit impact of a small business abiding by these securities laws.

The U.S. capital markets are one of the most efficient markets for raising capital, but they could be improved. Unlike our global competitors, the U.S. markets rely on an informed retail investing public. These investors are the lifeblood of our capital markets. These investors come in various stages of a company's capital raising requirements. It is the U.S. investor that funds the economic vitality of our great nation. The SEC segregates the U.S. investor into two classes, accredited and non-accredited. The standards set by the Securities and Exchange Commission (SEC) for accredited investor (high net worth) are; liquid assets of at least $1 million, or an annual income of $200,000 for individuals, $300,000 for couples. By this definition, there are some five million accredited investors in the United States. Of the 51 million Americans that own individual stocks (as opposed to owning shares in mutual funds) 46 million would be classified as non-accredited.

All company's at one time or another were classified as small businesses. All company's need capital to implement their business plans. How company's raise this capital and at what stage of their development, dictate the type of investor they can use and the cost of that capital.

In 1982 the government created Rule 504 "The Seed Capital Exemption" for small businesses. Its intent was to create a tool for small company's both public and private to raise equity without huge costs and minimum government regulation. As Rule 504 proliferated up thru the mid-1990's, fraud crept into this form of offering. In 1998 the SEC enforcement arm trying to eliminate a scheme known as "Pump and Dump" amended Rule 504 to eliminate this abuse.

When the SEC amended Rule 504 and the NASD amended its listing requirements, it quite possibly may have eliminated a whole generation of future S&P 500 components. By trying to eliminate the fraud of a few it threw the baby out with the bath water. The NASD de-listed over 3000 company's off the bulletin board, over 50% of its components.

Whether Rule 504 could be amended again might be a moot point. The SEC and the press have created such a negative stigma, relating Rule 504 to fraud, that it might never be used again. Instead, my proposal would be to create a new Rule 509 offering exemption. It incorporates all the positives in Rule 504, 505 and 506 exemptions with the modernization of our financial markets and actually increases investor protection issues.

Highlights of a new Rule 509 would include:

- link Rule 509 with the qualified small business stock exemption under tax code 1202 and 1045
- issuer must maintain a website with current news & financials
- can be offered thru advertising, internet and mail using a similar NASAA model investor exemption approach
- offered to both public & private companies
- maximum offering 12 months $10 million - minimum offering $2 million

- audited financials yearly (private)

  audited balance sheets quarterly (private)

  publicly traded company's on national exchange would comply with reporting guidelines
- must use a NASD member underwriter
- maximum underwriter compensation is 15%
- must escrow proceeds until minimum contingency is met
- minimum revenue, assets etc. to use the exemption
- used for company's below $50 million in assets
- term sheet used for all investors
- prospectus/memorandum delivery required
- electronic annual meetings
- road shows on line
- can use an unlimited number of accredited investors, up to 35 non-accredited with financial sophistication or pre-existing relationship or unlimited number of semi-accredited investor - net worth of $500,000 or annual income of $100,000 per natural entity or $150,000 married and can invest up to $25,000 with the issuer every 12 months but can not exceed 10% of their net worth per year.
- minimum hold of six (6) months before they can be registered
- if using a convertible debenture or preferred issue cannot use if there is not a floor on the convertible price and it can not exceed 20% or more dilution of the shares outstanding

  unless -

- any offering which dilutes the outstanding stock by more than 20% needs shareholder approval

The Leadership Council believes an efficient capital instrument can be created on existing laws or can be amended to give small businesses cost effective capital with the public adequately protected.

ILLEGAL SHORT SELLING

Investors whose "short" stocks are despised by many company's because they profit from a company's misfortune and plunging market capitalization. Shorting a stock means borrowing shares to sell, then "covering" the loan by buying the company's stock on the open market.

Illegal short selling occurs in three categories.

First, where investors and broker-dealers heavily invested in a short position of an issuer, will disseminate false, negative information to drive the stock price lower, then covering their position. Short-sellers can use the news media or a more cost effective approach, the Internet.

Second, when short sellers ambitions concern a hostile takeover it will grossly exaggerate or falsely spread negative information to drive down the price of the target company. This allows the takeover company to accumulate cheap shares.

Third, when "toxic convertible" investors short shares to drive down the conversion price of their note. By driving the share price down before the conversion date occurs, the investor receives more shares of common stock than if the market had been allowed to trade freely. These investors are in effect hedging their position.

It is "naked" shorts that the SEC should focus on. A "naked" short is selling a stock short without ensuring that the stock can be borrowed or otherwise provided for by settlement date, also known as an affirmative determination. The NASD prohibits "naked" short sales. In order to short a stock, your broker-dealer needs to locate stock before they can loan it to you. If they can't find any stock to loan, you can't short it. It sounds good in theory, but when a company has enormous short interest, sometimes the amount of shorts outnumbers the shares on the publicly traded float. How can this be? The reason is "naked" short selling. Someone is shorting the stock without first locating it. Market-makers and foreign institutions are usually the cause of this situation.

I have listed some possible solutions to these abuses:

- same "uptick" rules should apply to all stock exchanges (bulletin board, small cap) as a requirement to make a short sale
- broker-dealers should be required to meet the same coverage requirements for "naked" shorts as applied to investors and 100% haircut on such shorts should be enforced against violations
- a mechanism needs to be implemented to track short selling
- shorting of bulletin board, NASDAQ small cap and NMS stocks below certain price ranges should be prohibited
- shorting of all stock within ten (10) business days after effectiveness of an IPO should be prohibited
- the identity or organizations holding 5% or more of the outstanding shares or 10% of the public or float, of an issuer would be required to file a new 13S with the

SEC. Those that have beneficial ownership must file a 13-D, why not make those holding substantial short positions report also.

- once a broker "locates" stock he can not use it again, ex., Banks must maintain certain reserve requirements, set thresholds for the broker-dealers

Generally, short sellers make an invaluable contribution to the market, by stabilizing the market in extreme over-bought and over-sold situations. It is when fraud is the short sellers main ambition, usually involving small cap securities, that damage our financial markets.

The SEC and NASD haven't taken the necessary steps to correct this situation. There are now cases where company's are contacting their shareholders to call their brokers and have their shares taken out of street name so the broker-dealer can's lend them to the short sellers. There are even cases of shareholders banding together to fend off the short sellers.

Having shareholder's band together and company's encouraging their shareholder's to request their stock certificates, can not be good for our capital markets. The abuses occur most of the time, in the small cap markets where small businesses go for their capital. If the public loses faith in these markets, the ability to raise much needed capital for small business will be jeopardized.

MINIMUM STOCK LISTING REQUIREMENTS

A company's stock price should have no bearing on listing requirements. When a company's stock price approaches or drops below minimum listing requirements it actually fosters fraud and unethical practices. By imposing an artificial guideline in a free market mechanism, it forces management of public company's to take swift dramatic steps to correct the situation. If a company's stock price is nearing or drops below its listing requirements it is usually because of market conditions, economic conditions, industry conditions, or failure of its business model, of which three of them are out of management's control.

A company's management has limited options to keep itself from being de-listed. It could create artificial demand by issuing press releases, hiring promoters or reverse split its stock. All of these efforts are usually offset or exceeded by the short-sellers.

Once a company is de-listed the ability to raise capital becomes virtually impossible. If a company is successful raising capital at this point, the costs of this capital are usually enormous. The reason is if a company is de-listed its volume tends to decrease because many institutions and market makers will participate in national exchange listed securities only.

The NASD, SEC and State Regulators have numerous laws and regulations already approved to deal with the SEC's main concern about low-priced securities (known as "Penny Stocks"). All the exchanges carry minimum listing requirements, of which stock price is only one component used for continuation. All exchanges have provisions for minimum revenue, earnings, assets, shareholders, market capitalization, etc., or combinations of these factors. These are the provisions management should focus on, not stock price.

Common stock market wisdom says, "Implement your business plan and the stock price will take care of itself".

DEATH SPIRAL CONVERTIBLES

"Toxic Convertibles" or another well known name "Death Spiral Convertibles" have exploded over the last five (5) years. In 1995, a total of thirty-six (36) "toxic convertibles" raised $274 million, according to private equity tracker direct placement.com. In 2000, 220 toxic convertibles were completed, accounting for $3.2 billion of the $18.3 overall (PIPE) industry. Private Investment in Public Equity (PIPE) deals have become a major source of capital for public company's. PIPE deals have a place in our market, but it is their offspring the "toxic convertible's" that need to be regulated. In simple terms, a "toxic convertible" is a private placement that enables the investors to convert their securities at a discount to the current market price, usually with no floor or as to how low the conversion can go.

It is the long-term common stock investor that gets burned by these PIPE deals. A study done by Pierre Hillion, showed an investor who buys the common stock of an issuer loses, on average, 34% of his investment one year after a "toxic convertible" is issued. The study done from 1995-1998, is remarkable because their sample coincides with one of the strongest bull markets in history. In 2000, their were 220 "toxic convertibles" done, only five (5) were at a higher price then before the deal.

It is obvious the common stock investor is getting burned by these convertibles. The State of Wisconsin Investment Board has threatened to sue any of its portfolio company's that get involved with (PIPE) transactions.

Possible Remedies:

- a floorless convertible investor cannot hedge its position, short its position
- require convertible holders to file a new 13S filing, if the conversion is greater than 5% of the outstanding shares or 10% of the float.
- eliminate completely
- require floors
- eliminate variable or rest provisions

Out of the top 10 funds that invest in (PIPE) transactions, the number one fund over the last 12 months returned a whopping +599.88% and the number 10 fund returned +185.72%.

If the SEC can't find a way to enforce these convertibles, my advise to investors, "Don't invest in the company, invest with the funds." A 599% return in a year isn't too shabby.

RULE 144 HOLDING PERIODS

The evolution of technology has expanded rapidly into our financial markets. Moore's Law (computer processing speeds will double every eighteen (18) months) has crept into the financial markets, but has negative impact on investors. Rule 144 relates to the period an investor must hold onto a security before it can be sold. Current laws require a minimum of one (1) year for non-affiliates of the company and two (2) years for affiliates. Roughly 40% of the S&P 500 is made up of technology company's. The problem is, technology changes so rapidly that holders of stock in these hi-tech issuers become absolete before they can sell them. By lowering the holding periods from one (1) year to six (6) months for non-affiliates and two (2) year to one (1) year for affiliates, we will give the investor ample opportunity to exit his investment. This will cause both positive and negative consequences.

On the positive side, the lock-in effect of all the private placements done to date will create increased government tax receipts at ordinary income tax rates not at capital gains tax rates. Although being taxed at higher rates might be viewed as a negative, it is better than losing your entire investment and using it for tax losses. Another benefit would be the trillions of dollars that could be used to re-invest in new ventures. Another benefit is the cost of capital for these issuers would be reduced dramatically because the investor could become liquid at a faster rate. The shorter the holding period, the lower the discount.

On the negative side, this greater liquidity could induce fraud and issuers would have a greater amount of free trading stock hitting the markets.

SMALL BUSINESS IRA (SBIRA)

According to the Employee Benefit Research Institute (EBRI), less than one-fourth of workers at businesses employing fewer than 100 workers participate in a retirement plan. According to the most recent data available from the US Department of Labor, 79% of full-time employees in medium and large size firms are covered by an employment-based retirement plan, compared with 46% in small firms.

According to the 2001 Small Employer Retirement Survey (SERS) sponsored by the (EBRI):

- Reasons cited by small employers for not offering a retirement plan-Employees prefer wages and/or other benefits (19 percent); revenue is too uncertain to commit to sponsoring a retirement plan (18 percent); a large portion of workers are seasonal, part time, or high turnover (15 percent); it costs too much to set up and administer (12 percent); required company contributions are too expensive (10 percent); the business is too new (6 percent); and too many government regulations (4 percent).
- Nonsponsors' lack of familiarity with different retirement plans-Nonsponsors may be unaware of all the plan options available to them as small businesses. Many report that they have "never heard" of the following plan types: simplified employee pensions (SEP) (52 percent); traditional pension or defined benefit plans (36

percent); savings incentive match plan for employees (SIMPLE) plans, which were created by Congress specifically for small employers (34 percent); deferred profit-sharing plans (23 percent); and 401(k) plans (2 percent).

- Motivators cited to sponsor a retirement plan-An increase in the business' profits (44 percent of nonsponsors); a plan with low administrative costs that required no employer contributions (35 percent); business tax credits for starting a plan (23 percent); a plan that could be tailored to the unique needs of their business (23 percent); a plan with reduced administrative requirements (18 percent); availability of easy-to-understand information (19 percent); allowing key executives to accumulate more in retirement plan (16 percent); demand from employees (15 percent); repeal of top-heavy rules (10 percent); a plan that could be set up and administered completely over the Internet (7 percent); and lengthening of vesting requirements (7 percent).

What is interesting about this study, The Government can address certain issues and modify or create new plans to deal with small business owners concerns.

Certain issues that small employers cite for not offering a plan, cannot be addressed by congress such as: employees prefer wages (19%), workers are seasonal/part-time (15%) and the business is too new (6%). If you add these up (40%) of small business owners you will never get to sponsor a plan.

Committing to a retirement plan (18%), costs to administer (12%) required contributions (10%) and Government regulations (4%), this amounts to (44%) of small business owners concerns for not offering a plan. Congress could help implement changes to help with these issues.

Lack of familiarity with different retirement plan options can be accomplished with more education.

All of the motivators Congress can address.

Now that we know why small business owners do not offer a plan, what can we do?

401(k) is a perfect instrument for small business if the costs, administration and top heavy requirements were lowered or eliminated.

SEP/SIMPLE/IRA are perfect instruments for small business if the requirement for mandatory contributions and top heavy requirements were eliminated.

My proposal, The Small Business IRA, (SBIRA) takes the best benefits of 401(k)'s, SEP's, SIMPLE's and IRA's and combines them into a simple, cost effective instrument for small business owners.

(SBIRA) Highlights:

- no mandatory contributions, like the 401(k) but can offer voluntary matching contributions
- a simplified tax form, example form 5500
- eliminate top heavy restrictions
- offers up to $10,000 per year for all owners and employees
- ease of use, little education needed to administer the plan

I am sure congress can draft a retirement vehicle that small business can embrace.

SMALL BUSINESS HEALTH INSURANCE PROGRAM (SBHIP)

The Health Insurance Association of America (HIAA) has developed a package of proposals that are intended to address the growing number of Americans who lack health coverage. Employee benefits are a small business owners biggest expense. Lack of healthcare coverage for its employees, puts the employer as a major disadvantage in hiring from the labor pool roughly 70% of the small business owners do not offer healthcare benefits to their employees. Cost is really the only benefactor.

I support three parts of (HIAA) proposal:

- Small employer tax credit for health insurance premiums
    - 40% credit for employers with fewer than 10 employees
    - 25% credit for employers with 10-25 employees
    - 15% credit for employers with 26-50 employees
- Allow employee contributions for health insurance to be excluded from taxable income (even if not made through a section 125 cafeteria plan).
- Allow individuals to deduct the cost of health insurance premiums (including allowing the self-employed to fully deduct the cost of health insurance premiums immediately)

(HIAA) Estimates:

- About 71 million people would be eligible for the tax credit, either through their employer or the employer of their family head, 20 million of whom are currently uninsured. We estimate that as a result of this credit between 2.6 and 4.1 million uninsured will gain coverage as a result of the tax subsidy at a cost in revenue expenditures of between $23.8 and $29.3 billion annually.
- Exclusions from taxable income for employee contributions to employer coverage. About 750,000 and 1.2 million individuals would gain coverage as a result of this proposal, at an annual cost in revenue expenditures of between $6.4 and $7.4 billion.

- Deductibility of premiums for individual purchasers including the self-employed would cover between 1.5 and 3.5 million individuals could gain coverage through the individual market. Costs to the Federal government would be between \$7.8 and \$8.7 billion in lost income tax annually.

There are 42 million Americans that are uninsured. Although, the proposals I listed would only eliminate 4.8 - 8.8 million uninsured and cost \$38.0 - \$45.4 billion to the government, it would help small business owners become more competitive in the labor pool.

QUALIFIED SMALL BUSINESS STOCK (QSBS)
(Internal Revenue Code 1202 and 1045)

Small Business Capital Formation received a massive windfall when the Revenue Reconciliation Act of 1993 was passed. The act gives limited exclusion for non-corporate taxpayers for 50% of any gain from the sale of "Qualified Small Business Stock" held for more than five (5) years.

In 1993 the maximum federal income tax applicable to capital gains was 28%, so a 50% reduction lowered it to 14%. When congress passed the Taxpayer Relief Act of 1997 and lowered the Federal Tax Rate from 28% to 20% it did not include a reduction in qualified small business stock, so it currently stands at 14%.

My proposal is to first lower the five year rate down to 10%, where it should have gone after the Taxpayer Relief Act of 1997 was passed. Second, if the taxpayer continues to roll the gains into other qualified small business issuers at lower capital gains rates. I propose for every year after the initial five year holding period that the tax rate drops 1% per year for ten (10) years. After ten (10) more years in the program the taxpayers capital gains rate would be zero on any gains rolled over for fifteen (15) consecutive years. My rationale is simple risk versus reward. Every time the taxpayer rolls into another qualified small business issuer, the odds of success diminish rapidly. Venture capitalists are successful two (2) out of every ten (10) investments are. The better V.C.'s might average three (3) successes out ten (10). The taxpayer has only a 20% chance of success on his first investment based on professional V.C. numbers. Odds are the taxpayer will have even lower odds of success. Reason, a professional venture capitalist spends 300 hours per investment idea in due diligence. I doubt the average accredited investor is spending this much time per investment. The laws of diminishing returns are against the taxpayer, but for their risk we should reward them with lower capital gains rates.

Third, (QSBS) should apply to all company's not just certain industry's.

Fourth, get rid of C corporation only clause and open it up to sub-chapter S corporations, limited liability corporations and partnerships.

Fifth, eliminate AMT Tax provisions.

Sixth, increase roll-over period to 180 days from the current 60 days.

Seventh, eliminate the maximum gain provision completely.

Although, this is one of small businesses best capital formation tools to attract investor, nobody can use it in it's present form. According to the 2001 budget, only $40 million in tax expenditures were declared. Clear evidence, this is a tax break nobody can use.

CAPITAL GAINS TAX RELIEF

"To Spend or Save" that is the question. Under our current tax code, we reward the consumer who takes the money they earn and spends it. If they spend instead of save their wages they are rewarded with lower taxes. On average, the consumer may pay 5% sales tax to buy a new T.V. but if they invests it into General Electric, the manufacturer of the T.V., and sells it for a capital gain, the investor gets taxed at 20%. If the investor sells it under one (1) year they are taxed at their ordinary tax rate, which could be as high as 39.6%. To spend (5% taxation) or save (39.6% taxation) no wonder the household savings rate (percent of disposable income) for our country is lower than most developed nations, averaging below 4% for the last decade.

No one has yet to convince me that a capital gains tax benefits our economy. In fact, I have never read any article, seen any research or heard anyone say capital gains tax benefits our economy. Why? Because it doesn't. If you do believe that capital gains tax benefits the economy then what you are saying is that the 20% tax the investor is getting penalized for being right would be better spent by the U.S. Government, not the investor.

Economic growth depends on quantities of capital and labor and the productivity of these factors. Economic growth cannot occur unless productivity improves, quantities of capital and labor increases or both. Investment capital is critical for the economy. High capital gains tax rates lower the return on investment, thus increasing the cost of capital and depressing overall investment in the economy. Consequentially, a capital gains tax reduction would lower the cost of capital and stimulate investment. Increasing capital formation would be felt throughout the economy in the form of increased jobs, better standards of living and higher wages.

Since the end of The Cold War, which lasted some 45 years, the U.S. has been reaping the rewards of victory. New global markets in which to sell our goods and services.

It is not a coincidence that our ten (10) year bull market traces back to the fall of the Berlin Wall. America's new enemy is global competitiveness for its goods and services. The U.S. Capital gains rate exceeds that of any industrialized nation except the U.K. and Australia, however these nations index for inflation. Now the U.S. must compete globally for capital. Higher capital gains tax rates puts U.S. industry at a competitive disadvantage for capital. Almost every industrialized nation experiences higher savings, investment and productivity growth rates compared with the United States. We need to eliminate or reduce our capital gains tax rate to stay competitive in the new global economy.

I think Federal Reserve Chairman Alan Greenspan said it best in his testimony before the U.S. Senate Banking Committee on February 25, 1997: "The point I made at the budget committee was that if the capital gains tax was eliminated, that we would presumably over time see increased economic growth which would raise revenues for the personal and corporate taxes as well as the other taxes we have. The critical issue about the capital gains tax is not its revenue-raising capacity. I think it is a very poor tax for that purpose. Indeed its major impact is to impede entrepreneurial activity and capital formation. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argue that the appropriate capital gains tax rate was zero.

How do we help small business capital formation? Eliminate or reduce the capital gains tax. Here are some reform initiatives:

- Eliminate the capital gains tax altogether. Many of our global competitors have no capital gains tax.
- Index for inflation, if we can't lower the capital gains tax rate, at least we could index it for inflation. We index every other government program to inflation.

- Eliminate capital gains taxes for those securities that have a market capitalization below $250 million dollars. A bill introduced in the House of Representative Jim Greenwood would accomplish much of this.
- Reduce capital gains tax - any reduction would benefit small business. Two capital gain tax reduction proposals have already been submitted, S.66, a broad-based capital gains proposal introduced by Senators Hatch, Lieberman, Grassley and Breaux, which provides for a 50% exclusion for individuals and a 25% corporate capital gains tax rate and H.R. 14, introduced by Representatives Drier, Hall, McCarthy, English and Moran which provide for a 14% marginal rate for individuals and 28% rate for corporations among other provisions would help small business capital formation.
- Rollovers - Have a program similar to the housing rollover where if you hold the asset a predetermined number of years, say 5 years, you can continue to rollover the capital into another investment without incurring capital gains taxes until such time you decide to cash out, as long as you reinvest the assets within 120 days.
- $500,000 lifetime capital gains credit - Have a program similar to the Housing Program, where you get up to $500,000 in capital gains excluded from tax during the lifetime of an individual. It wouldn't cover property, collectibles etc., but it would include stocks, bonds, mutual funds etc.
- Holding period incentives - A program where the longer you hold an asset the lower the capital gains.

Example:	Holding Period	Capital Gains Tax
	0 - 1 year	ordinary income tax rate

1 - 2 years	20% capital gains tax
2 - 3 years	15% " " "
3 - 4 years	10% " " "
4 - 5 years	5% " " "
5 + years	0% " " "

These are only a few ways to reduce the tax burden on the money we have already been taxed on.

GUARANTEED COLLEGE EDUCATION PROGRAM (GCEP)

To increase productivity and stimulate economic activity, businesses need a qualified educated work force. Due mainly to the lack of capital, small business is at a severe disadvantage when it needs to hire employees. Large company's have the necessary capital and employee benefits to hire the best educated from the labor pool. Those employees not taken by the large employers are generally what small businesses have to work with. What is disturbing is that large company's cannot even find enough qualified employees to hire. A case in point, the uproar in HB-1 visas. The visas allow foreign workers to fill job vacancies in our country. The number of visas allotted for 2000 was 115,000 and we reached this number in six (6) months. The high-tech industry is scrambling to get congress to raise the number of visas north of 200,000 annually to fill their employment needs. If Silicon Valley gets its way, that is 200,000 jobs lost by U.S. citizens a year.

The objective of the guaranteed college education program (GCEP) is to provide college education to every citizen born in the U.S. starting January 1, 2002. The national interests of the USA both economically and socially are served by a better educated citizenry and workforce. Post secondary educational needs will increase growth in importance as dramatic technological changes occur. The U.S. workforce will be at a competitive disadvantage in the world without continuing education and enhanced sophistication in the workplace. Additionally, social relations in the U.S. will suffer as the disparity on wealth becomes increasingly proportional to those with advanced knowledge that is not available to all Americans.

The theory behind GCEP is post secondary education must be made possible for every American. GCEP will provide targeted money to students who are willing and able to continue their education. The program will enable children to pay for their own educational costs respective of family or social circumstances. If a child wants to attend college, that child will have means to attend.

GCEP starts when a child is born in the U.S. and receives a social security number. The Federal Government will then purchase an average of $10,000 worth of U.S. Government Treasury Strips in the child's name and social security number. The funds will be put into an escrow account and will mature around the child's 18th birthday. Upon the child's receipt of a High School Diploma or equivalent (GED) and accepted into an accredited institution, the child will receive a swipe card from the Social Security Administration to be used for tuition, books, fees and other pertinent educational costs directly from their account. The child will have until their 35th birthday to use the entire amount of their funds for educational pursuits or the remaining money will revert to the Social Security Trust Fund or pay down the National Debt. The $10,000 initial deposit will mature to roughly $30,000. According to preliminary research regarding cost of state colleges in the year 2020, $30,000 is projected to provide four (4) years of state college education.

Intended Outcomes:

- a large influx of students into colleges
- post-secondary education would become a growth industry
- increase in High School diplomas with each child knowing that money will be available to go to college
- a possible way to break some cycles of poverty through educational advancement
- could use GCEP money for advanced degrees; such as masters degree, a different undergraduate, technical degree or a doctoral program
- consolidation of multiple post secondary education programs thus saving overall administrative costs through economies of scale - example: Pell grants, Perkins loans, etc.
- starting in the year 2020, all higher educational programs could be eliminated
- used in conjunction with existing scholarship programs such as Hope. If a child loses their scholarship could remain in school using GCEP.

Funding:

- Initial outlay of $40 billion a year. 4.0 million children born in the U.S. every year multiplied by an average of $10,000.
- As of 1996, 81.5% of dependent 18-24 year olds had graduated High School and 58.9% had at least some college experience, according to higher education analysts at The University of Iowa. Using 1996 data, $40 billion x 81.5% x 58.9% = $19.2 billion actual cost of program in 1996 dollars assuming they attend all four years of college.

$ 9.1	Pell Grants est. 2001
49.0	Student Loans est. 2001
+ 3.4	Other Programs est. 2001

$61.5 Total Federal Program est. 2001

- 19.2 GCEP Program

$42.3 Billion savings to government per year starting in 2020

- could take $500 of the child tax credit roughly $20 billion/year to pay for program
- defaults on student loans are running at $25 billion/year, which is costing the taxpayer

There are numerous open issues such as: The Social Security Administration's infrastructure, re-engineering and support able to administer the GCEP, whether the government can even do this, whether the funding should be wholly financed, jointly financed through a partnership with private industry or as a sponsored private corporation.

Using 1991 data as an example of wage differences; college graduates earned $23.42/hr., some college $15.46/hr., High School graduates $13.28/hr. and High School drop-outs $9.79/hr., it is apparent that even a little additional education results in much higher standard of living, increased federal tax receipts and a better labor pool

In conclusion, changing a child's mindset at a very early age (I can go to college) might help break some generations of family socio-economic circles prevalent in the lower income groups. The elimination of dozens of federal programs and cost savings to the government. Basically what the government is doing is expanding K-12 to K-16. I think our nation's greatest resource, human capital, is worth $40 billion a year.

IN CONCLUSION

The Leadership Council recommends establishing a small business task force to evaluate proposed, existing and pending laws and regulations that affect small business. The Leadership Council is willing to take an active role in establishing this task force and will work with regulators, market practitioners, issuers and investors to make recommendations that address the interests of the small business community.

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