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ENCOURAGING SMALL BUSINESS GROWTH AND ACCESS TO CAPITAL

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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ENCOURAGING SMALL BUSINESS GROWTH AND ACCESS TO CAPITAL

Thursday, September 23, 2004

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

The subcommittee met, pursuant to call, at 11:23 a.m., in Room 2128, Rayburn House Office Building, Hon. Sue Kelly [chairman of the subcommittee] presiding.

Present: Representatives Kelly, Paul, Inslee, Moore, Maloney, Crowley and Davis.

Chairman KELLY. [Presiding.] This hearing of the Subcommittee on Oversight and Investigations will come to order.

This morning, the Subcommittee on Oversight and Investigations convenes to continue its review of efforts to encourage small business growth and access to capital. Small business drives our economy and creates jobs for millions of Americans. In fact, small businesses currently generate nearly three-quarters of the net new jobs per year and employ approximately one-half of the private-sector workforce.

Capital is the lifeblood of small businesses and the efficient access to capital is a crucial ingredient to a strong, growing economy. We must ensure that our small businesses have access to capital and that the current regulatory scheme encourages future growth and development.

Available data shows that small businesses are recovering from the downturn in the economy begun in 2001 in no small part due to the easing of their access to capital. Banks began relaxing lending standards in late 2003 for the first time since 1998. In turn, demand for small business loans has recently increased.

In terms of our equities markets, over 100 companies have undertaken initial public offerings so far this year, making it the best year for new offerings since 2000. Despite these promising numbers, there are still significant regulatory hurdles discouraging small business capital formation.

Last Congress, the Subcommittee on Oversight and Investigations held a hearing entitled "The SEC's Role in Capital Formation: Help or Hindrance?" In this hearing, the subcommittee heard from a number of witnesses who contended that the SEC has simply not kept pace with the needs of small businesses despite their best effort. Since that time, Congress has passed and the President has signed important legislation known as Sarbanes-Oxley to improve auditing standards, disclosure rules and corporate governance.

While investors in small companies expect and deserve the same protections as those in larger companies, this law places a renewed focus on the need to review the current regulatory framework to ensure that small businesses are able to develop and access capital. There must be concentrated effort to modernize our federal securities regulatory framework to ensure that we are protecting investors, but allowing small businesses to grow.

Today, we will review the steps that our government is taking to address the specific needs of small businesses. In 1996, under the National Securities Markets Improvement Act, Congress was very clear that the SEC ensure competition, efficiency and capital formation in its rulemaking.

This law also granted the SEC general exemptive authority to ease regulatory burdens and to meet the needs of all businesses, large and small, trying to access the capital markets. Regrettably, the commission has not been as proactive in exercising this authority to support the needs of small businesses.

It is time to embrace the advantages that new technology and the Internet have brought to our society and could bring to our government agencies. While the SEC has tried to simplify registration and other regulations for small businesses, these tasks remain extremely daunting for the average small business owner.

There is a tremendous amount of cost and effort that a public company must incur to access the capital markets and comply with federal securities laws. In their pursuit to protect investors, the SEC must also make it a priority to strive for more efficient regulations. The current regulatory regime must keep pace with the market and the needs of small businesses. Otherwise, investor protections are also going to be undermined.

The commission's inaction has motivated me to draft with my colleague from New York, Representative Nydia Velazquez, the Increased Capital Access for Growing Business Act, H.R. 3170. This legislation removes certain obsolete investment limitations on business development companies which were created in 1980 by Congress to encourage investment in small developing and financially troubled businesses.

By simply modernizing securities laws, this legislation would allow BDCs to provide significant resources to small businesses as originally intended by Congress. Since the commission's position on the legislation has been frustratingly unclear, I urge the SEC to take this opportunity to express their support for this legislation that would have a tremendous impact on the ability of small businesses to access capital.

The legislation was first introduced last Congress, passed the House unanimously and now awaits Senate consideration. After working with the SEC on the legislation for several years, it is time for the commission to give a public endorsement of the bill and help small businesses by moving the process along in the Senate.

I thank all the witnesses for their appearance before the committee to address these important issues. It is my hope that we together will make progress that will enable small businesses to devote their energies to their customers, and not outdated and inefficient requirements that no longer reflect the realities of our new economy.

[The prepared statement of Hon. Sue W. Kelly can be found on page 30 in the appendix.]

Without objection, all members's opening statements will be made part of the record.

I would like to turn now to Mr. Moore. Mr. Moore, do you have an opening statement?

Mr. MOORE. Madam Chairman, I do not have an opening statement. I do appreciate the witnesses here today and am anxious to hear their testimony.

Chairman KELLY. Thank you.

Mr. Paul?

Mr. PAUL. I do not have an opening statement.

Chairman KELLY. Mr. Paul has no opening statement.

Mr. Inslee?

Mr. INSLEE. Briefly, perhaps everyone is aware of this, but I think probably every member of Congress when they return on the weekends talks to small business members about the cost of compliance of Sarbanes-Oxley. It is particularly acute, obviously, for small business people. I just think over the next year or two or more, I hope this committee will be engaged in a continuing effort to see if there are ways to accomplish our purposes and reduce that obligation of small business owners.

I just throw out the idea almost that we ought to even have tiger teams looking for any possible things we can do to reduce the cost of compliance as this process goes along. I just hope we look at it as an ongoing process, because it is a very, very important thing and we all hear it in 435 districts. So I look forward to any ideas. Even though a rule has been adopted, I do not think it is the beginning of the end. It is the end of the beginning.

Thank you.

Chairman KELLY. Thank you very much.

We turn now to our first panel.

Testifying on our first panel is Mr. Alan Beller, the Director of the Division of Corporation Finance and Senior Counselor at the U.S. Securities and Exchange Commission. Mr. Beller joined the SEC in January of 2002. Prior to joining the SEC, Mr. Beller practiced law concentrating on a variety of domestic and international corporate securities and derivatives issues.

Without objection, sir, your written statement will be made a part of the record. You will be recognized now for a 5-minute summary of your testimony.

If you have not testified before in front of this committee or any other committee here on the Hill, there are black boxes at either end of the table. They will be lit first with a green light, which means you have 5 minutes. The yellow light means please summarize. The red light means 5 minutes is over.

We now turn to your testimony, and we welcome you. Thank you.

STATEMENT OF ALAN L. BELLER, DIRECTOR, DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION

Mr. BELLER. Thank you, Chairwoman Kelly, members of the subcommittee. I am pleased to appear before the subcommittee today on behalf of the Securities and Exchange Commission.

The stated mission of the Securities and Exchange Commission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. The commission has long strived to balance its mission to facilitate capital formation with its mission to protect investors.

For example, while we can carefully consider how our regulatory scheme impacts small businesses, we also believe that investors in small companies deserve a proper level of disclosures and equivalent protections to those of investors in larger companies.

In most cases, we believe the two goals complement each other. The public is more likely to invest in our capital markets if they believe that their investments are being protected. The strength and vigor of our markets, including our markets for small business issuers, notwithstanding the difficulties that you have mentioned and that we are aware of, are we believe unmatched and are ample proof of this very important fact.

Our mission to facilitate capital formation requires us to consider carefully how our rules and regulations impact small businesses. In order to ensure that we do this, the SEC has taken a number of steps to focus on small businesses.

Primary among these is the Office of Small Business Policy in the Division of Corporation Finance. The office directs the division's small business rulemaking initiatives and interpretations and comments on SEC rule proposals affecting small companies generally. It also answers questions received from small businesses by telephone or at its e-mail address, and works with outside groups concerned with small businesses.

The head of the Office of Small Business Policy also serves as the commission's Special Ombudsman for Small Business. The SEC created this position in 1996 to represent the concerns of smaller companies within the entire SEC. The ombudsman also answers general questions from small businesses.

The disclosure operations section of the Division of Corporation Finance, whose primary role is to review registrant filings, is central to the mission of the Division. Disclosure operations is divided into 11 groups, 10 of which are organized by industry type.

The 11th group is the Office of Emerging Growth Companies, which reviews substantially all of the initial filings of small business issuers. We feel that the small business expertise that is developed within this office is as important to small businesses and investors as the industry expertise that exists in our other groups.

In addition to these offices, which serve as resources for small business, the commission has a special page targeted to small businesses on its Web site. This special page includes material created to help small businesses understand how to raise capital and comply with the federal securities laws, as well as links to other information of interest to small companies.

We also coordinate with other government regulators to discuss issues related to small business. In April of this year, we held our annual conference with state securities regulators at which we discussed methods of achieving greater uniformity and effectiveness in securities regulation. The SEC staff also works closely with the Office of Advocacy at the U.S. Small Business Administration on regulatory matters affecting small entities.

I want to talk a moment about the Government-Business Forum on Small Business Capital Formation. Since 1982, under the mandate of the Small Business Investment Incentive Act of 1980, the SEC has sponsored this forum. It is an annual meeting that provides the only government-sponsored national forum for small businesses to let government officials from different parts of the federal government know how their laws, rules and regulations impact smaller companies. This year's forum was held just this past Monday at our headquarters here in Washington.

The focus of this year's forum was, first, developments in auditing and their impact on smaller public companies; and second, the current challenge to smaller public companies related to disclosure and SEC filings and corporate governance.

I want to pause. If you are familiar with some of the requirements of Sarbanes-Oxley, as I know you are, I think you will understand that these two focal points of the forum were, I think, direct results of the concerns of small business and smaller companies that have been referenced with the expense and difficulties of complying with Sarbanes-Oxley for smaller companies. That definitely was a focus of this year's forum.

The recommendations that came out of the forum, I think the primary recommendations, we are still reviewing them. We just had since Monday to sort out what the primary recommendations were. Quite clearly, the most important recommendation is to deal with the impact of the internal control assessment and audit requirement of Sarbanes-Oxley on small business.

Other important recommendations involved our exemptions in rules that accommodate capital formation by small businesses, and the status of nonregistered intermediaries, sometimes called "finders," in the capital formation process.

The finder recommendation was also an important recommendation of last year's forum and our Division of Market Regulation is currently quite actively involved in looking at questions related to how the registration requirement for broker-dealers impacts the processes of paid intermediaries such as finders, who help small businesses raise money.

The Division has been in discussions with many small business representatives, including a group formed under the auspices of the American Bar Association. It is addressing the important question of what sorts of requirements and what aspects of the registration process are or are not appropriate for application to those sorts of intermediaries. Obviously, the task for us there is to balance the need to facilitate capital formation with the very important mandate to protect investors. That is what the division intends to do.

In terms of our regulation of small businesses more generally, a number of our rules and exemptions are specifically tailored to provide accommodations for small businesses that seek to raise capital in the U.S. Some of the accommodations come in the form of general exemptions to our registration requirements that apply only to small businesses. Others are general exemptions that in fact by their nature have greater or special applicability to small businesses.

These rules and regulations are detailed in my written testimony, but briefly, Regulation A provides an exemption from reg-

istration for nonreporting issuers issuing up to $5 million in any 12-month period. Regulation D is an exemption that has several prongs to it. Most importantly for small business Rule 504 exempts offerings of up to $1 million in a 12-month period and allows for the issuance of freely tradable securities if the companies make offerings in accordance with State laws.

Rule 506 permits sales without limitation to accredited investors and to a limited number of nonaccredited investors who are sophisticated. Finally, Rule 701 exempts from registration sales of securities of private companies to their employees. That has been a very important element in allowing small businesses and other private companies to retain their employees and compensate them appropriately before they go public.

We have received suggestions, including from the forum, to increase the amount of capital that can be raised under these exemptions and to loosen the conditions. We are always willing to, and frankly are always in the process of, considering those recommendations and balancing them against the overall context of our investor protection mandate.

In addition to the exemptions, we have a regulatory regime for public companies that is designed specifically for small businesses. They have a special set of disclosure rules that are simpler and easier to comply with than the rules for larger companies. They have a special set of registration forms that is also easier to comply with.

An issue that small businesses now consistently face with us involves the Sarbanes-Oxley Act of 2002 and our rules implementing that act. In doing that implementation, we tried very hard to be sensitive to the concerns of small business issuers.

We made a number of accommodations for them that are detailed in my written testimony. I am happy to discuss them further.

Despite these accommodations, we have heard, as has already been suggested by a member of the subcommittee, that some smaller public companies are burdened by the new rules.

I think we agree that the rulemaking process that we have now completed is not the end, but the end of the beginning. We intend to consider over the coming months what, if any, appropriate steps we can take to recalibrate the way the regulatory system affects small businesses.

The staff is actively in listening mode. I think the commission is actively in listening mode. I think we are going to seek advice wherever we can get it. We will try to come up with the best solutions that we can.

I think everyone recognizes that in doing that recalibration, it is important to keep front and center the principle enshrined in Sarbanes-Oxley that improved corporate governance, improved financial reporting, improved auditor performance are important for all companies regardless of size.

The last thing I would like to touch on a little bit is use of technology. I know it was raised in the last hearing, the importance of the SEC coming to grips with changes and improvements in technology.

I think since 2001, the commission has in fact to a greater degree than ever before embraced new technology, embraced the use of the

Internet. All-Internet offerings are something that we have now, at least in one case, blessed and in others would consider. The whole Internet auction process is now something that we have not only accepted, but frankly facilitated in initial public offerings. The use of company Web sites for posting of information is something that we encourage, consistent with companies continuing to comply with their reporting requirements with us.

We do continue to have concerns about the use of the Internet for private offerings where access to the offering material is not restricted to the appropriate target class of investors. That is a concern that we continue to balance against the important advantages that the Internet and technology offers.

We are in the course of a fairly significant overall reform project of our Securities Act offering processes. One element of that project, when it comes out as a recommendation to the commission and if the commission approves, would be a proposal that would involve updating the communications process to permit use of the Internet and other new technologies in ways that are currently not permitted by the statutory restrictions. We are cognizant of the need to be responsive to technological developments.

Chairman KELLY. Mr. Beller, if you could sum up.

Mr. BELLER. I think that is the last point I wanted to address from my written testimony.

All I would say again is I thank you for the opportunity to be here today.

The SEC has long considered small businesses to be an important part of our regulatory responsibilities. We have looked and we are continuing to look for ways to accommodate small businesses in the fulfilling of our dual mission of facilitating capital formation and protecting investors.

I would conclude by saying I would be pleased to answer any questions that Chairwoman Kelly or any other members of the subcommittee might have.

[The prepared statement of Alan L. Beller can be found on page 32 in the appendix.]

Chairman KELLY. Thank you very much.

I am interested in the definition of small companies. There are a number of different definitions used. Standard & Poor's uses, for instance, a small cap index as a $300 million to $1 billion company. Some people find it difficult to consider that that is a small company.

But the question is, if you have a company that is $300 million to $1 billion, how complicated, how difficult is it for them to access capital? I am wondering if the SEC should reexamine size standards for some of these small businesses.

Mr. BELLER. For purposes of our regulations directly related to small businesses, the defined term involves assets or revenues of $25 million, that is assets or revenues. So that is not anywhere near the $250 million level.

So, for example, our Regulation S-B, for special disclosure rules, our special forms tie to that number. I am sorry, it is market cap and revenues, not assets and revenues.

I think the other important cut-off we have in our regulatory regime is that companies with market cap of $75 million or more are

eligible to use shelf registration for primary offerings. Companies of $75 million are similarly defined as accelerated filers in our new rules that have shortened the period in which companies have to file their quarterly and annual reports.

Chairman KELLY. Mr. Beller, my question really was, do you think you should reexamine the size standards for these small businesses, the ones that you use?

Mr. BELLER. What I think we have to focus on is two things, for example, whether the $25 million is the right level or whether it should be $50 million, for example; whether the $75 million for some purposes is maybe even too small; and also whether there should be different levels for different purposes.

I am thinking particularly of the internal control requirement in Sarbanes-Oxley, where I think we are hearing, and I would not be surprised if the members are hearing, that $250 million is a definition for small business. Companies with $250 million of market cap find the internal control requirement to be a burdensome requirement in its current form.

So yes, we should think about changing them, but I think also we should think about whether there ought to be maybe different levels for different purposes.

Chairman KELLY. I am glad to hear you say that.

Also I am glad that in your testimony, you finally acknowledge the need to modernize some of our security laws relating to the BDCs. Representative Velazquez and I have been working on this legislation now for two Congresses. It has passed the House unanimously.

In spite of all this support and no opposition, we continue to ask the SEC for feedback. Don't you think our legislation would help many of these small businesses access capital?

Mr. BELLER. We certainly agree with the premise of the legislation that the changes in the margin rules in 1999 had an unacceptable impact on the operation of the definition for eligible portfolio companies. We have been in communication with your staff on an ongoing basis on the legislation and the rulemaking that you mentioned that is being considered within the staff at this point.

The commission has not taken a position on the legislation. I know that it has passed the House. I know that it would deal with the eligible portfolio company issue.

I am more than pleased to take back the request to the staff of the Division of Investment Management. The BDCs do not come under the jurisdiction of the Division of Corporation Finance. I am happy to take that request back to the Division of Investment Management and back to the commission itself and get you an answer, but I cannot answer that question today.

Chairman KELLY. I wish you would come back to us with an answer for that question.

One of the problems that I see with small business issues at the SEC is they cut across a lot of different internal divisions of the SEC. I am wondering if it would not be better at the SEC, if it would be better for the people in the businesses and the SEC itself, if you had some sort of a small business policy office that was a part of the Division of Corporation Finance, but separate from, so that they could be within the umbrella, but separate so there is one

way for those of us in Congress and the businesses themselves to get some clarity and specific direction. I think it would speed up a number of issues.

As I said, Ms. Velazquez and I have been working on this for 4 years and we do not have a response from the SEC. We would really appreciate getting one.

I also would hope that you would come back to us with your thoughts about the idea of having a specific separate small business policy office. I think that would be very helpful for some of these businesses and for the SEC.

I am out of time. I am going to turn now to Mr. Davis.

Mr. DAVIS. Thank you.

Mr. Beller, I probably will not use my full 5 minutes, but I wanted to go back to the area of your testimony that relates to Sarbanes-Oxley. I was reviewing the part of your written testimony that deals with some of the allowances that have been made for small businesses who may be struggling, or who will eventually struggle with the compliance aspects of Sarbanes-Oxley.

Let me ask you a broader philosophical question. What is your position or the SEC's position on whether Sarbanes-Oxley ought to apply to certain small businesses at all?

Can you talk about whether there is any strong public interest or any strong public policy rationale that dictates that Sarbanes-Oxley even apply to a lot of these smaller companies?

Mr. BELLER. Sure. I would answer that in two different ways.

One, as a regulatory agency, we take our direction from Congress, of course. The Sarbanes-Oxley Act of 2002 does not itself make any distinction between larger companies and smaller companies. I think we take that direction very seriously. So the direction from Congress is in a sense the benefits in that statute are to be directed at all of our reporting companies.

The second answer I would give you is that consistent with that direction, I think the commission's philosophical view, and certainly mine, is that the benefits of Sarbanes-Oxley to improved financial reporting, to improved disclosure, to improved performance by auditors, to improved corporate governance, and to improved performance of people, gatekeepers like lawyers and accountants and underwriters and analysts, all of those improvements are important to companies of all sizes.

So the statute correctly directs us, if you will, as a philosophical matter, to apply its principles across the board.

Mr. DAVIS. Let me ask a different follow-up. Let's say that in the 109th Congress for whatever reason we were to take a look at Sarbanes-Oxley and we were of a mindset to make some changes in it, recognizing that we make the policies and theoretically you do not.

Give me some guidance if Congress were to be interested in carving out exceptions for small businesses or if Congress were to be interested in creating a different set of standards. Give me some guidance of how we ought to be thinking about that process.

Mr. BELLER. I think the honest answer to that is that we have certainly heard enough regarding the impact of the burden of the requirements to assess and audit internal control over financial reporting, that certainly the Chief Accountant of the Commission,

Don Nicolaisen, and I have both indicated publicly that we would like the private-sector individuals, principally an organization called the Committee of Sponsoring Organizations, or COSO, we would encourage COSO to think about whether they should develop an alternative framework that would apply to smaller companies. I actually think that that would be the most appropriate way to address that burden, and I think before we were to do something, before the PCAOB were to do something and before Congress were to do something, I would like to see what COSO is prepared to do.

Beyond internal control, what I said earlier holds. We are at the end of the beginning. We have completed the rulemaking process. We have now very actively entered listening mode, both at the commission level and the staff level. I think we are not bashful at all about our eagerness to get outside help in that listening mode.

Mr. DAVIS. Let me try to slip in one question while I have a little bit of time left on the clock.

Can you comment on an issue that, as you know, has been very controversial in this chamber and is now before the other body, relating to expensing of stock options?

Of course, as you know, the House passed a particular bill and the Senate right now is reviewing it. It is unlikely we will get a final product before we adjourn.

Can you comment for a moment on whether it makes any sense to carve out exceptions to the expensing rules for smaller businesses?

Mr. BELLER. I think my answer to that would be the same as the commission's answer has been with respect to that issue generally. Our chairman is certainly very clearly on record as to this.

We believe that the right place for these questions to be dealt with is the FASB. We think the FASB has an open and appropriate due process. The question of whether there should be different treatment for smaller companies and whether there should be different treatment for private companies has certainly been presented to the FASB. That is where I would look to get the answer to that question.

What I think we are committed to do once the FASB has acted is to provide appropriate implementation guidance so that the rule that the FASB comes out with is a rule that is appropriately implemented by the companies large and small that it would apply to. I think that is where we are.

Mr. DAVIS. I think my time has expired, if the Chair would give me an additional 30 seconds.

One of the controversies as you know has been the degree to which we should be deferential toward FASB. We have had a fairly strong discussion over that.

So if you can answer just theoretically, if Congress were to decide to put some kind of restraints on FASB's decisionmaking process, as the House has already done, what should we be looking at if we were to try to do some kind of a carve-out for smaller companies to make them less subject to the full expensing requirements?

Should we be looking at the small companies in the same way we look at the large companies when it comes to the expensing issues?

Mr. BELLER. Again, I think my answer has to be that we would encourage leaving this to the FASB and not the legislative process. I am not sure I can give any more guidance than that.

Mr. DAVIS. Okay. I will take the witness's answer as I do not think I am going to get another one, Madam Chairwoman.

Chairman KELLY. Thank you, Mr. Davis.

Mr. Paul?

Mr. PAUL. Thank you, Madam Chairman.

Your mission has been described as protecting investors, ensuring orderly markets and promoting capital formation. I am going to ask the question, then I am going to develop a little bit.

Has it ever crossed your mind that this is an impossible mission and something that is unachievable?

The reason I ask this is that I think the wrong things get blamed for our problems. In the 1930s, we had a bad period of time. We had a crash in the stock market and we introduced this notion that all we needed were regulations and everything would be okay. And yet when they investigated the crash and the loss of funds in the late 1920s and early 1930s, they found out there was essentially no fraud. There was a financial bubble and there was a collapse. Yet during the 1930s, we kept introducing more and more regulations and kept the markets out of balance for a long period of time and things got worse. Therefore, there was no proof that regulations in the 1930s were helpful; maybe exactly the opposite was true.

Today we have problems. We had the collapse of the Nasdaq bubble, 80 percent, probably trillions of dollars lost. We had Enrons. And yet we did have the SEC and others sort of poking around there hoping to prevent this, and it did not do any good.

Our conclusion now is we need even more regulations, so the Congress responded. You are right. You do not create these problems. You do what we tell you, so we passed Sarbanes-Oxley and now you are making this effort.

I still maintain maybe the impossibility of solving our problems through regulation because we are not directing our attention to the problem. To me, the problem is the bubble. You do not create the bubble. As a matter of fact, nobody can prevent the correction once the bubble is created. Right now, we have had a partial collapse of the bubble, but we probably have a long way to go.

So far we as legislators always have to do something, and we are doing something, and you are responding and you are doing your best. But you are involved in trying to cause capital formation while what we are doing is causing costs of capital formation to go up.

I do not think we have the right definition of "capital formation" because in a free market economy capital comes from savings. It does not come out of the thin air. I think what we talk about when we talk about capital formation, and when you talk about it, I think you are alluding more to allocation of credit, how to send some credit over into small business in places where we think it is necessary.

I think that is completely different than capital formation. Capital formation means productivity and savings, yet our savings rate

is real low, so we are not doing a heck of a lot to create real capital. Of course, we do create credit out of thin air.

I just am concerned that we are on the wrong track, and that all your good efforts will not pay off very well because we have not asked the question: How have we created the bubble and the collapse and the mal-investment and all the debt in the system?

And some people lose money, and we have very disorderly markets. When you think about it, they are very disorderly. Just one day this week, the dollar lost 1 percent. This affects everybody's investments, exporters and importers, and prices, and the whole works.

So once again, the question is: Has it ever occurred to you in the slightest manner that maybe the regulatory process is on the wrong track and it cannot solve the problems that we face?

Mr. BELLER. I guess I would say that I agree with you that the SEC is not, without trying to address whether there is a regulator or which regulator it is, the SEC is not the regulator to address issues of bubbles and collapsing of bubbles and productivity and savings rates and the other things that you very properly allude to as the critical underpinnings of a capital market.

I think when we talk about capital formation, what I think we think our mission is, is to eliminate obstacles in the way that markets operate, including regulatory obstacles, that is, thinking about our own rules, that keep the capital formation process that you are talking about from operating in a free market, competitive way. I think that is a mission that we can appropriately address.

I think there is evidence that it is a mission that can be consistent with our investor protection mission if we do it right. I think that the fact that the global markets, which have lots of models available to them other than ours, the global markets have more often than not followed the U.S. lead in terms of both the way we regulate markets to encourage capital formation and the way we regulate companies to facilitate their being able to raise capital and to foster investor protection.

I think that trend following the U.S. lead in the global markets is actually also true of Sarbanes-Oxley. If you look at what is happening in Europe, certainly, and what is happening in some parts of Asia even, you will find best practices and legislation and EU directives, all of which to some degree mimic what Congress did in Sarbanes-Oxley and what we did in implementing it.

So I think if you narrow what capital formation means to the narrower concept that I think we use, and not savings and productivity and the like that are really not part of our function, I think the mission is a possible one. The mission can be swamped by forces outside our control. That is, bubbles can come and go and our regulatory function does not really address them in any way.

Mr. PAUL. May I have 30 seconds for one quick one?

Chairman KELLY. So ordered.

Mr. PAUL. If there is an argument made that these regulations are too great a burden for the small company, wouldn't this be the perfect argument to show that if it is a burden to small companies, it is also a burden to the large company and it would make the case that all the regulations are not beneficial.

Mr. BELLER. It would, and I think we do think about that. I think if you take internal control as an example, though, I think you can fairly reach a conclusion that differentiates larger companies from smaller companies.

The internal control mechanism at larger companies depends on processes, depends on checks and balances, depends on documentation. And properly so, because there is no one consciousness that knows all the things that are going well or going badly across the board.

A smaller company, you will find, and certainly when we get down to the $25 million level, you will find that it is the rule, rather than the exception, that the CEO knows everything that is going on, or the CFO knows everything that is going on in the financial area.

The right kinds of control mechanisms and the right kinds of assessments really could be different in that environment. So when we talk about right-sizing the framework for thinking about internal control, it is those kinds of issues. I think you can get to saying small businesses ought to have different treatment or ought to be recalibrated.

There are other instances where, as you say, you can fairly argue that what is burdensome for the small companies is proportionately burdensome for the large companies and why are we doing it at all. We do think about that.

Chairman KELLY. Thank you, Mr. Paul.

Mr. Beller, there is clearly some overlap between the work of the SEC and the work of the Small Business Administration for small private businesses and small public companies. Especially there is an overlap when small businesses reach the point where they want to go public.

I am interested in the fact that the SBA I know has written to the SEC for comment on proposals that could have an impact on small businesses. I want to know what the SEC is doing to be proactive for the small businesses? How are you working, what are you doing to try to work more closely with the SBA to make that juncture a little easier for people to navigate?

Mr. BELLER. I think we have good relations and good communications with the Small Business Administration, certainly with the Office of Advocacy. The head of our Office of Small Business Policy is in I would say ongoing communication with them about their concerns and our concerns.

Chairman KELLY. But you do not have a small business advocate at the commission, nor does the commission have one person designated to be a small business liaison. That might help, don't you think?

Mr. BELLER. I took your earlier point about whether it should be someone within the Division of Corporation Finance or whether there should be a separate office. I think we feel we do have someone who acts as a liaison between the agency and small business for all issues. That is the head of the Office of Small Business Policy.

You correctly observed that that office is within the division and I think fairly ask, is that the best place for it to be. But there is

such a person, and that person certainly believes that part of his function is to be the liaison.

We will certainly take your question back and consider it. I would say that one of the reasons that person is in the division—and in a sense it could be in any of three divisions: there are four divisions in the SEC—and functions that get spun off outside those divisions, they think more multi-divisionally, but they risk becoming orphans. That is, I think, the issue we have to address in thinking about the right place for that office.

But we do have an office. The man who heads that office firmly believes, and I as the division director firmly believe, that he is the liaison between the commission as a whole and small business. We talk to the other divisions about that liaison function.

Chairman KELLY. Is that apparent to the small businesses who need that person?

Mr. BELLER. I think we try to make that point extremely clear. I think, for example, the small business forum, the forum that was just held last Monday, is organized by that office. It is held by that office, organized by that office, but the subjects that are raised include the finders issue from market reg; include BDC issues and investment management.

The small businesses who participate in that forum, I think it is crystal clear to them that the head of that office is the liaison for all purposes within the agency, yes.

Chairman KELLY. Since you brought up the small business forum, there was in the report, I think it was this last report, that there was a recommendation that the commission create a position to act as a small business liaison, and that one commissioner serve as an advocate.

I think that that is something that we would be very interested in seeing happen. I would hope that you will consider that. You seem to indicate that you will.

We thank you very much. The Chair notes that the U.S. Small Business Administration will submit a statement in writing due to their inability to be appear before this subcommittee today.

We thank you very much for appearing here, Mr. Beller.

The Chair also notes that some members probably will have some additional questions for this panel which they may wish to submit in writing. So without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their response in the record.

We thank you very much, Mr. Beller. We appreciate your sharing time with us today. Thank you.

Mr. BELLER. Thank you for the opportunity to appear before you. Thanks very much.

Chairman KELLY. Thank you.

As Mr. Beller leaves, I would like to bring up our second panel. We have several private-sector witnesses to discuss the current state of small business development and access to capital.

Our first witness is Ms. Joan M. Sweeney, the chief operating officer and chief compliance officer of Allied Capital in Washington, D.C. Ms. Sweeney has worked with Allied Capital since 1993 and oversees the company's daily operations. Prior to joining Allied

Capital, Ms. Sweeney was employed by Ernst and Young, as well as Coopers and Lybrand and the SEC Division of Enforcement.

We welcome you, Ms. Sweeney.

Also appearing on our second panel is Mr. Frank Speight, chairman and chief executive officer of American Capital Partners in West Palm Beach, Florida. Mr. Speight is representing the National Small Public Company Leadership Council, a Washington, D.C.-based group seeking to educate the White House, Congress and federal agencies about the economic contribution of small publicly held companies.

In addition, we also hear from Mr. Thomas Schneider, the President and chief executive officer of Pathfinder Bank in Oswego, New York. Mr. Schneider will be representing America's Community Bankers, an advocacy group of community banks whose members have assets which aggregate more than $1 trillion and pursue progressive entrepreneurial and service-oriented strategies in financial services to benefit their customers and communities.

Our final witness of the day is Mr. James Connolly III, the President of the IBA Capital Funding in Perrineville, New Jersey. Mr. Connolly is representing the CEO Council, a group which advocates on behalf of CEOs of small public companies. Mr. Connolly is also the director of the new business development of InvestTrend, a fee-for-service financial analysis organization.

Without objection, your written statements will be made part of the record. You will each be recognized for 5 minutes.

We will begin with you, Ms. Sweeney. We welcome you here.

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

Ms. SWEENEY. Thank you, Madam Chairwoman and members of the subcommittee. I am Joan Sweeney, the chief operating officer of Allied Capital Corporation. We invest in the American entrepreneurial economy as the nation's largest business development company or BDC.

Thank you for the opportunity to discuss the essential role that BDCs play in providing growth capital and expertise to smaller businesses.

I also want to thank you, Madam Chairwoman and Congresswoman Velazquez, for your efforts in passing H.R. 3170, the Increased Capital Access for Growing Business Act. If enacted, this important piece of legislation will increase the number of American companies that could access capital from BDCs.

Allied Capital has been investing in growing businesses for 46 years, and over that time we have provided financing to thousands of companies. Our assets today are over $3 billion and we have investments in 116 portfolio companies, which generate aggregate annual revenues of approximately $11 billion and employ more than 105,000 people.

We provide both mezzanine debt and equity capital. We believe that smaller companies need additional financing sources. The U.S. financial services industry has been contracting as a result of consolidation. This trend has reduced the amount of debt capital available to smaller companies. In addition, the cost of being a public company in a post-Sarbanes-Oxley world is higher than ever. Going

public has become less attractive, and more companies are seeking private financing options.

Small public companies, however, cannot turn to a BDC as a private financing source because under current law they are not eligible. This is unfortunate because BDCs, as regulated entities, provide transparency as to their investing activities and are a natural match for smaller companies.

Deprived of this option, many small public companies, desperate for capital, have instead sought private financing from private equity and hedge funds, which provide private investment in public equities, or PIPE financing.

These unregulated funds have little transparency as to their activities, and may not have the best interests of the small company in mind. Some have even structured "death spiral" PIPEs where the fund intends to profit from the fall of the small firm's stock price.

Congress saw the need for alternative financing sources for small companies in 1980 when it created BDCs. In defining the types of businesses eligible for BDC financing, Congress defined an "eligible portfolio company" as a company that did not have a class of marginable securities under the rules of the Federal Reserve.

According to the legislative history, Congress intended the pool of eligible portfolio companies to be very broad, and it was estimated that 8,000 of the 12,000 publicly traded companies at the time would be eligible.

However, in 1999 the Federal Reserve greatly expanded the definition of marginable securities. Today, any security listed on the Nasdaq stock market is considered marginable, which is a substantial shift from what was marginable in 1980.

The Federal Reserve's changing view of marginability collided with congressional intent for BDCs and drastically reduced the universe of companies eligible for BDC financing. Small public companies needing cash for growth are no longer eligible, and recently questions have been raised about the eligibility of private companies with outstanding debt securities, since debt securities are also now marginable.

BDCs may invest limited capital in companies that are not eligible, but we do not think there should be any limit when it comes to providing growth capital for smaller companies.

One investment that Allied Capital made is in a small public company called Blue Rhino, which you may recognize as the supplier of the propane gas cylinder for your outdoor grill. This company came to us in 2001 for $15 million in financing. Their stock was trading at only $3.70 per share, and their market capitalization was less than $100 million. They were not suitable for a secondary public offering.

Our financing enabled the company to grow its sales substantially in 2001 and 2002. The company increased in value, its shareholders benefited, and Allied Capital's shareholders benefited with a capital gain.

BDCs work well. BDCs can play a much more meaningful role in providing capital to entrepreneurial companies if the definition of "eligible portfolio" company is updated.

We encourage the subcommittee to review the rulemaking activity of the SEC to ensure that the definition is appropriately amended both to restore Congress's original vision and to provide consistency with the provisions of H.R. 3170.

Thank you for the opportunity to testify today.

[The prepared statement of Joan M. Sweeney can be found on page 58 in the appendix.]

Chairman KELLY. Thank you very much.

We move next to Mr. Connolly.

STATEMENT OF JAMES A. CONNOLLY III, PRESIDENT, IBA CAPITAL FUNDING, REPRESENTING THE CEO COUNCIL

Mr. CONNOLLY. Thank you. Good morning, Chairwoman Kelly and members of the subcommittee.

Chairman KELLY. It is a busy day.

Mr. CONNOLLY. I am certainly aware, and I thank you for taking the time. I do not know that I will be as compelling to listen to as Mr. Allawi, but I will try. I have congratulated Ms. Sweeney for truly cooking with gas, as Blue Rhino is certainly a great stock and a valuable addition to the marketplace.

To begin again, good morning, Chairwoman Kelly and members of the subcommittee. First, allow me to thank you for the opportunity to appear before you to present a somewhat different perspective than has been heard here today on small business capitalization as experienced by the over 7,000 publicly traded companies currently listed on either the Over-The-Counter Bulletin Board or the Pink Sheets.

We are gratified that our efforts to communicate with the Congress and relevant federal agencies, under your leadership as advocates for small business, results in my appearance here today.

My name is James Andrew Connolly III. I am a native New Yorker and am here as a founding member of the CEO Council, a Maryland-chartered 501(c)(6) organization of small public company executives, with both a growing network of local chapters and an expanding membership base throughout the country.

Our stated purpose is to enhance the public markets for investors and couple this with affordable financing options for smaller public companies. We are seeking to achieve these goals with both a member-driven advocacy effort, along with supplementing the information available to the markets as to the opportunities open for investment in these engines of economic growth, job creation and innovation.

Our market space of 7,000 companies includes hundreds of millions of dollars in market capitalization, tens of thousands of employees, and likely hundreds of thousands of stockholders. We are the dirty little secret of the securities markets, much maligned, overregulated, and often referred to as "penny stocks" in the same sentence as "scam."

I can state with certainty that the perception of fraud is not the same as fraud, and the substantial majority of these companies are operated in an ethical and businesslike manner. They are responsive to their customers, good employers and contributors to their communities along the way. They operate in all 50 States and probably in most congressional districts. They range from startups to

well-seasoned enterprises who all share the competitive challenges of a global marketplace, a recovering economy and the burden of often-unaffordable compliance costs.

It is frequently the case when apportioning resources that a microcap CEO is compelled to choose between expanded reporting costs and new hiring, payroll and benefits or audits and expanded legal advice. Public transparency costs, whether as traditional investor relations or fully compliant research dissemination, director indemnification or liability coverage, without which many of these companies cannot attract qualified outside directors, compete for scarce corporate resources and are therefore often lacking.

Heretofore, our microcap colleagues have had to compete without being able to collectively represent their interests as significant contributors to the economic well being of the United States, not to mention often very good investments without running the gauntlet of regulatory indifference at best, and outright hostility to our continued existence at worst.

This has not occurred in a vacuum. There clearly have been instances of abuse. We hear of them in the press when advised to avoid penny stock investments, and unfortunately with regular and necessary enforcement actions that become highly publicized.

Taken cumulatively, these facts explain both the virtual impossibility of obtaining either startup or expansion capital on terms that are rational, as well as diminished liquidity in secondary trading.

Undoubtedly, the modern era of instant execution, online trading and affordable transaction costs, combined with the relative lack of substantive reliable data on many microcap securities, has led to an overall lack of transparency and created multiple opportunities for both fraud and market manipulation.

The CEO Council was formed with these challenges in mind and has worked deliberatively over the past 3 years to effect what we hope are progressive changes.

We took an early and active role in opposing the BBX as envisioned by Nasdaq. They, like all profit-motivated organizations, hoped to escape the costs of regulating the Over-The-Counter Bulletin Board without provision for the thousands of companies who either would not, could not, or chose not to list, thereby relegating them to Pink Sheet status, which demonstrably would lead to a major loss of both market capitalization and reduced investor liquidity.

The council has maintained an active presence at the annual, most recently on Monday concluded SEC Government-Business Forum on Small Business Capital Formation held every year since Congress mandated it in 1980.

We have contributed to its agenda and suggested several of the hundreds of recommendations that small business owners, regulators and industry practitioners have suggested for implementation. Sadly, far too few have been adopted or implemented. As a matter of fact, Madam Chairwoman, virtually every year one of those recommendations is to re-adopt the recommendations from the year before.

It often seems that the various, admittedly dysfunctional divisions of the SEC are in conflict with each other when responding

to our concerns. The perception of enforcement appears to be guilty until examined innocent. Corporate finance clearly has a Fortune 1000 focus, and it is left to the small business ombudsman, Mr. LaPorte, to represent our interests within the bureaucracy, often to no avail.

I have included with my written testimony for the subcommittee's review the recommendations from 2002 and 2003.

If I may, just as an aside, I would like to point out that recommendation number 24 last year was mine. It called upon the SEC to work diligently to expand financial literacy within the investor community so that investors are much more confident and aware of the realities of investing.

The NASD has had some significant negative effects on our marketplace as well. In their determination to disallow broker-dealers to receive any compensation for filing form 15(c) 211, despite substantial costs to fully due diligence a listing, the 200-plus market makers in Pink Sheet-listed companies shrank to 40 active submitters, creating less than a fully open and competitive marketplace.

If the attorneys and accountants have no problem being paid for rendering professional services and are fully registered, licensed professional market makers who, through their due diligence prior to a filing, are the first line of defense against fraud, any less deserving?

Time does not permit me to cite many other obstacles microcap companies encounter in a full discussion here today, but with your indulgence I will cite three other significant proposals that the CEO Council would recommend.

Firstly, I am aware that there is interest at both the American Stock Exchange in New York and the Pacific Coast Exchange in San Francisco in the development of a specialist-based new venture or microcap exchange. This should be fully explored at both the SEC and the NASD, neither of which appear to be overly interested in those proposals from the indications I have received, as its potential for small company access to capital is very promising.

Secondly, we would like to propose a new regulatory regime for small business issuers. This might include consultative roles for organized participation by all elements of the capital markets with investor advocates, institutional investors, regulators, issuers and other interested parties operating in a framework to create what some have called the "enterprise exchange." There are opposing views on whether a specialist or a dealer market is a better solution, but we believe this is worth exploring.

Finally, we believe that regulation 15(c) 211 should be improved and streamlined, such that nonreporting issuers should provide financial information to the marketplace, and that regulation 15(c) 211 should be right-sized to fit this goal.

Additionally, despite multiple efforts, some with very substantial congressional support, I might add, the information on this form which every publicly traded company in the Pink Sheets or Bulletin Board needs to file to effect trading, and therefore is available in the repository of the NASD, and I believe in most cases at the SEC, could form the basis of informed investor interest and is maintained by the NASD, where individuals have been refused by them to have these documents fully disseminated to the public as

filed. There are data vendors who would gladly supply this information, several free of charge, as transparency, we all agree, is a paramount goal.

Investor protection and small business capitalization need not be mutually exclusive and hopefully this dialogue today will add to the efforts expended by many of us who are deeply concerned that without both regulatory changes and a more fully informed investor base through increases in financial literacy, coupled with enhanced disclosures, the microcap marketplace can once again thrive and be a hotbed of innovation and growth for our economy.

Thank you for hearing our concerns today, as well as your willingness to address them. I know the members of the CEO Council are pleased to be a resource. We hope you will call on us in your future efforts to keep our markets the most efficient and transparent in the world.

With your permission, we would like to add to the record in the allotted record period time. Thank you again.

[The prepared statement of James A. Connolly III can be found on page 47 in the appendix.]

Chairman KELLY. So moved.

Thank you very much.

Mr. Speight, we welcome you here today.

STATEMENT OF FRANK SPEIGHT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICAN CAPITAL PARTNERS, LTD., REPRESENTING THE NATIONAL SMALL PUBLIC COMPANY LEADERSHIP COUNCIL

Mr. SPEIGHT. Good morning, Madam Chairwoman and members of the subcommittee. I want to thank you for the opportunity to appear before you today to testify on the issue of small business access to capital.

My name is Frank Speight. I am the founder, chairman and CEO of American Capital Partners, Limited, a registered business development company which is based in West Palm Beach, Florida. I also serve as co-chairman of the National Small Public Company Leadership Council, a Washington, D.C.-based group that seeks to educate and inform the White House, Congress, and federal agencies about the crucial issues impacting the nation's small publicly traded companies and the economic contributions that those companies are making.

Let me first congratulate Chairwoman Sue Kelly on the House passage of the bill called Increased Capital Access for Growing Businesses Act, H.R. 3170, that would modernize outdated securities laws to ensure that small businesses have better access to capital through business development companies, or BDCs.

We have enjoyed working with Congresswoman Kelly on behalf of the Leadership Council. It is exciting to see the first fruits of her efforts to broaden access to capital for BDCs, which are publicly traded investment companies that invest in both public and private companies and generate necessary injections of capital for all businesses.

I am here today in support of her efforts and to urge that access to capital be broadened to encompass all small and developing companies. Small business is the engine of the economy.

The ability of small business to raise funds and have access to loans or the necessary capital markets is essential. When small businesses do not have the capital they need, they are unable to make the investments they require to grow their business. This, in turn, hampers growth in the overall economy. We must do all we can to create a greater access to capital markets for all small business.

An important step in providing greater access to the capital markets for small public companies can be taken by reinstating a modified and updated version of SEC Rule 504, which was among the reforms created by the Reagan Administration.

For small businesses in particular, the paperwork and legal costs are prohibitive oftentimes for raising money through the capital markets. The Reagan Administration wisely knew that the SEC Rule 504 made it easier for small firms to raise money from the stock market by exempting them from many SEC regulations and registrations if they raised $1 million in a calendar year.

To briefly review, the results of Reagan's SEC reforms were immediate. Small businesses fueled the boom of the 1980s and 1990s. Small businesses quickly realized that they could raise capital as never before, and the sector became the engine of growth for the new economy.

For example, in 1984 two friends who owned a small ice-cream shop in Vermont wanted to build a full-fledged manufacturing plant to sell their product nationally. The friends decided to bypass an underwriter or a broker and raised $750,000 by selling directly to Vermont residents. A year after raising this seed capital, Ben & Jerry's listed on the Nasdaq and soon became one of the best-selling brands in the United States.

According to a report in The New York Times in 1983, the SEC's changes under the Reagan Administration had brought an additional $500 million into the markets in less than 2 years.

Also, as Philip Koslow wrote in his book, The Securities and Exchange Commission, published in 1990, "The SEC's new approach undoubtedly contributed to the expansion of the markets and the growth of new capital. Wall Street, which had seen some hard times since the 1970s slump, began to boom. New buildings were going up throughout the financial district in lower Manhattan, and firms were hiring thousands of new workers. Suddenly, Wall Street was the place to be for energetic and ambitious young people. All this activity clearly bolstered the economy in the short run."

During the early 1990s, the reforms of Rule 504 were liberalized even further and once again small businesses fueled an economic boom. According to the Small Business Administration, more than one-half of all U.S. employees work for companies with 500 employees or less. These firms produce 47 percent of all business receipts and nearly all the new job growth. Firms with more than 500 employees actually had a net decrease of jobs from 1992 to 1996. Some economists credit small business for the dramatic growth in American productivity that was responsible for the incredible prosperity of the 1990s.

But since that era, the SEC has found many excuses to roll back the reform policy that the Reagan Administration put into place.

During its reign, Rule 504 successfully proved to build prosperity by giving small companies more access to the capital markets.

The SEC would argue, as I heard today, that Rule 504 still exists on the books. But in reality, the SEC has taken the teeth out of the measure and it is of little use, by relegating the decisionmaking process to the States and taking it away from the federal level.

Under the former 504 guidelines, accredited investors could receive unrestricted securities for their investment, thus allowing them the necessary liquidity to lessen their risk exposure. It also allowed them the opportunity to more quickly reinvest the proceeds from an investment into another small public company and there expand the capital base.

There is a tremendous need to modernize outdated securities laws to ensure that small businesses have better access to capital.

My recommendation is a reinstatement of SEC Rule 504 to its former parameters, but with several modifications. These changes would be to increase the annual cap on the money small businesses can raise to $2 million, from the former $1 million. This would allow small microcap public companies the access to the levels of capital they truly need in today's marketplace.

Also, require the SEC to develop some kind of mechanism to streamline the process for filing. If a small public company is current in its SEC filings, they should be allowed to file an easy 504 notification filing, with supporting documentation such as a legal opinion letter on EDGAR, similar to the current same-day filing S-8 that is currently in place for compensating consultants.

Madam Chairwoman and members of the subcommittee, small businesses are the backbone of our economy. There is no question about that. It is critical, absolutely critical, I believe, for small businesses of all kinds to have more access to capital in order to create jobs, buy products, invest in this beautiful country of ours, and ensure a strong and growing economy.

Thank you, Madam Chairwoman, for your time.

[The prepared statement of Frank Speight can be found on page 55 in the appendix.]

Chairman KELLY. Thank you very much, Mr. Speight.

Mr. Schneider?

STATEMENT OF THOMAS SCHNEIDER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PATHFINDER BANK, REPRESENTING AMERICA'S COMMUNITY BANKERS

Mr. SCHNEIDER. Good afternoon, Chairwoman Kelly and members of the subcommittee. Thank you for inviting me to testify. I am Tom Schneider, President and CEO of Pathfinder Bank in Oswego, New York. Pathfinder is a community bank traded on Nasdaq with capital of $22 million. I am here representing America's Community Bankers.

I am proud to report that the climate for small business in my community is improving. Small businesses are the economic engine in our country. They are our job creators and they are vital customers for my bank. Small businesses are growing and creating much-needed jobs, often because community banks across our nation focus on helping local businesses with their capital needs.

Oswego, New York, is located in the old manufacturing heart of our nation. As the U.S. economy has shifted from a manufacturing economy to one that is service-oriented, our community has had to adapt. Pathfinder Bank has been proud to provide capital to aid in that transition. My bank proudly offers several types of financial products to meet the capital needs of the small businesses in the Oswego area.

One of the greatest tools we have is also one of the best private-public partnerships ever created by Congress, the programs of the Small Business Administration. The SBA is an excellent partner in carrying out the mission of providing capital to small businesses. We use two primary programs, the 7(a) loan program and the 504 loan program. These guarantee programs allow community banks the opportunity to provide capital to small businesses that would not otherwise qualify for credit.

We also offer something else. Community banks offer access to the decision maker, and that decision maker knows the people and the area. Because we know and understand the unique needs of small businesses, community banks are often more flexible in their decisionmaking. Often, making a loan decision will come down to the character and integrity of the applicant. As a community banker, I know the people of my community and I can make that decision

We have a vivid example of this in the case of the community hospital in Oswego. A few years ago, the hospital needed capital to renovate and expand services it provides in our community. It tried working with a large institutional bank, but the hospital did not meet the bank's cookie-cutter criteria and the hospital faced the prospect of being denied the funds it needed. We at Pathfinder Bank knew the hospital and the people running it. Working with another community bank, we were able to serve the people of Oswego by helping secure the financing for the hospital.

There is a second topic I would like to address today, the effect of the Sarbanes-Oxley Act. It has had an impact on how small, publicly traded banks such as Pathfinder do business. Ultimately, the legislation will make our economy stronger by increasing corporate accountability and providing greater confidence for investors.

However, small banks are seeing large cost increases. A recent survey of ACB members found that the biggest impact of Sarbanes-Oxley appears to be higher compliance fees and costs. Sarbanes-Oxley is important to reeling in the conduct of bad corporate lawyers, executives and accountants.

However, we believe that some of its provisions are unnecessary for the banking industry because we are already tightly regulated and tightly supervised by federal regulators. Parts of the law are particularly burdensome on the smaller community banks.

That is why we suggest that the costs and fees associated with complying with Sarbanes-Oxley may justify allowing smaller organizations to be exempt from portions of the law.

In addition, ACB and its members support efforts to see if there are requirements that can be streamlined or waived by the Securities and Exchange Commission to promote greater access to the capital markets for small businesses. While many of the existing

regulations may be necessary for larger and more complex companies, they may be an unnecessary obstacle to small businesses in seeking access to capital markets.

Because Pathfinder Bank is publicly traded, we have access to capital and can therefore make more loans to small businesses in our community. Before that, we were like any other small business. We had to seek capital so we could further expand our services and product lines, and more importantly hire additional employees.

I am proud to bring to the subcommittee's attention an effort to bring greater visibility and capital to community banks. In partnership with Nasdaq, we created the America's Community Bankers Nasdaq Index of over 500 community banks traded on Nasdaq. This focuses attention on community banks as a vital sector of the financial services industry and our nation's economy.

In conclusion, Pathfinder Bank and ACB believe there is a prosperous climate for Americans to start and to grow small businesses. Community banks across our great country are willing and able to meet the capital needs of small businesses.

Chairwoman Kelly and members of the subcommittee, thank you again for allowing me the time to testify today. I am available to answer any questions you may have.

[The prepared statement of Thomas Schneider can be found on page 50 in the appendix.]

Chairman KELLY. Thank you very much, Mr. Schneider.

I would like to ask you, Ms. Sweeney, if BDCs are allowed to invest in all private companies, Pink Sheet companies, bulletin board companies, any company that is facing some sort of a de-listing, would that increase the number of public companies to which you can offer capital assistance?

Ms. SWEENEY. Well, today, because of the way the Federal Reserve change happened in 1999, we cannot invest in any company that has a marginable security. So that under some very narrow interpretations would mean even private companies, if they already have an outstanding debt issuance to a private issuer, because that is a marginable security.

So what was proposed in H.R. 3170, which is essentially update the definition, allow BDCs to finance any company with a market capitalization of $250 million or less, that opens up the universe to all private companies and to small public companies.

Because I think you made an interesting point in the earlier panel, the definition of what is small, when it comes to a public company today, needs to be reexamined.

The S&P small cap index picks up above $250 million. There is this universe of companies below $250 million, Blue Rhino is a classic example, that need capital. They cannot access; they cannot do a secondary. There is no research on these companies. There are no investment banks who think they are worth their time for the fee that they will earn to raise the capital.

So we think that that definition, for very many purposes, needs to be reexamined.

Mr. CONNOLLY. Will you marry me?

[Laughter.]

Chairman KELLY. Mr. Connolly, do you want to comment on that?

Mr. CONNOLLY. Ms. Kelly, I must say, I have just asked Ms. Sweeney if she would like to marry me.

[Laughter.]

Those are the most incredible points that have not I think effectively been presented either to this committee, and certainly to the larger media, the public perception as well, is that we are bandits. Not for nothing, as they say I guess back in the 'hood.

I am a third generation in my family in the marketplace. My grandfather came back from World War I in 1915; went to work for Brown Brothers, and became a specialist in the New York Stock Exchange, probably mid-way when these guys were founded, the SEC. I do not know if he was responsible for the necessity of their creation.

My father was on the street for 30 years and when I was born he was working for the President's family's firm, G.H. Walker and Company. I have spent my professional career working to assist small public companies, both as a licensed professional regulated broker and also as an investor direct, specifically, venture, however one wants to define it. In that entire period of time, there are very, very few companies with market caps of over $250 million that I have even met.

So the truth of the matter is that the BDC bills, the support that you and Ms. Velazquez cumulatively have put behind that effort, and by the way we have been knocking on their doors for 3 years as an organization, the CEO Council.

So I would share your frustration, I suspect, in getting responses.

But you can do something about it. So to that extent, this hearing I think is a critical link in making both my community of 7,000 companies in the marketplace be aware that Congress is certainly concerned to the level of hearing, certainly considering potential technical corrections, I guess, if you were to the possibility of Sarbanes-Oxley looking at the issues that day to day the ladies and gentlemen of our community have to address.

Chairman KELLY. Thank you.

Does anybody else want to address that?

In that case, Mr. Speight, you started to talk about Rule 504. There is a problem evidently at the SEC in trying to balance the interests of capital formation and investor protection. It is a very tricky one, and it goes to what Ms. Sweeney and Mr. Connolly were just talking about. The problem is that investor protection sometimes seems to get in the way of the capital formation part.

Have you any suggestions to the SEC? Obviously, this is going to be printed testimony which we can pass on to the SEC. I would be interested in any suggestions you might have.

Mr. SPEIGHT. I honestly believe that you can have your cake and eat it too. I really do believe that you can reinstate something similar to the 504 exemption, increase the limits to it. All companies that would have access to it would have to be fully reporting companies. That obviously tells the marketplace the financials of the company, any changes that have been made to the company. I think that the commission can keep in place all the anti-fraud provisions in it.

I was in a meeting where a representative from the SEC basically told us that their estimate was that out of the 504 offerings,

about 1 to 1.5 percent were fraudulent. I think that is an overreaction to basically take the teeth out of an exemption that did so much for small companies because of 1 to 1.5 percent fraud. That is my opinion.

The predecessor company to American Capital Partners, Dunhill Capital, did 24 504 offerings in 1998 alone. That is $24 million that was pumped into small public companies and you can multiply us by thousands of other funding sources.

I think it is a travesty that they took the teeth out of something that allowed small companies to access $1 million a year in capital in such an easy way, and they could reinstate it and still keep the anti-fraud provisions in there, make the company report, make the company even file an immediate notification that they are doing a 504, and what the terms of that 504 are.

Let the public know. Let it be transparent. Nobody has a problem with that.

Chairman KELLY. One of the problems that the agencies in government seem to have, though, is that many agencies really do not have the funding right now to put in the information technology systems so that, for instance, you are talking about reporting.

One of the problems is that some of the rules that they promulgated back in the early 1900s still apply, so that you have to do certain things by written note and telephone because it is mandated in the rule.

Some of the rules need to be changed, but also I am hopeful that we can get the agencies to shift some of their funding priorities so that they can put in the information technology that is necessary so that we can perhaps open up the doors more, especially to something like the 504. We will have to wait and see.

I have one question here, if I can find it, for you, Mr. Schneider. In your testimony, you spoke of the existing SEC regulations that for the large complex companies, so they probably or maybe an unnecessary obstacle for the small business access to capital markets. You offered a couple of examples.

I would be interested if you have any ideas of what regulations you feel could be streamlined or eliminated beyond what you started talking about. I think you are in a very interesting position with regard to your bank being a small company, in a sense.

I know for a fact that when we wrote the Sarbanes-Oxley bill, there was no intent to try to curtail. There was only an intent to try to make a transparent system so that investors would feel comfortable, everyone could see what was going on in the companies and we could then have a certain comfort level with people investing in the market.

Obviously, there are some things there you would like to see changed. You suggested a couple of them. I would be interested in hearing any others.

Mr. SCHNEIDER. When it comes to the governance and the independence of the organization, those were very easy things for us to adapt to. I think we adopted a very comprehensive set of governance guidelines. Our audit committee was already functioning after years of examination by the New York State Banking Department and the FDIC. It was already functioning in a very independent and effective manner.

I think it is going to come about for us, and it is just transitioning now, but on the certification and attestation of internal control systems, which 305 does account for, and accounts for at the $500 million level. We are a $300 million bank. I think that that limit was put in there because the resources at our organization, and I was happy to hear Mr. Beller's comments regarding it because he seemed to be aware of the fact that in a smaller organization the knowledge of the internal control system is inherent in the CFO and the CEO positions.

But going through the process of that documentation now of that system is going to be very costly. That cost has already begun for us. I would probably put that cost somewhere at about $100,000 for us to get from here to there by December of 2005, which is the set of financials that we are going to have to put out that are going to have to be attested to by our external auditors.

After that, there is going to be the accelerated filings of 10Qs and 10Ks quarterly in annual reports. I think that that is going to be a difficult transition for smaller organizations, too. I think it is going to put a strain on the whole system. The external auditors that we utilize do not really get into it. We have a fiscal calendar-year end of 12/31. They do not get into us until February because they are working with their larger clients in January.

So I am not certain how we are going to be able to meet those accelerated 10K filing requirements if the access to, and many companies are running fiscal years on calendar years. I am not sure how you are going to get your access to your external auditors in time to go through that whole certification-attestation process, with everybody feeling comfortable that the external auditors are opining to the financial statements.

It just seems like, and I think you talked about technology and that solution perhaps lies there, but for us we are still operating with a good transaction processing system. It is not the greatest accounting system in the world, so it takes us a while. And that "while," frankly, is a better internal control because we are spending more time in the compilation.

I am not so sure that you can achieve both quality and speed simultaneously. I think that the quality is probably more important to the stability of the place than speed is at this juncture. Those would be the two areas that I would think are going to be cost-burdensome.

Chairman KELLY. Both of those areas are very serious things that we really do need to take a look at and work with.

I want to thank all of you for taking the time to come here to speak to us. I want to just simply throw out one more question to all four of you. Are there any messages that you would like to leave this committee with that you have not had the opportunity to speak about today?

Mr. CONNOLLY. Fairly simply from my testimony, Madam Chairwoman, the one item that I specifically alluded to crafting this statement relative to rule 15(c) 211 and its transparency.

That came as a shocking statement from the President of a firm called Knobias.com or "no bias" as it may be referred to, who is the repository as an information source for professional market players

and individuals of all data that is available for small fees in the penny stock and bulletin board arena.

The President of that firm, which is Mississippi-based, indicated to me that for the last 5 years, with some substantial congressional assistance, as you can imagine, it found a stone wall at both the NASD and the SEC in terms of getting that 15(c) 211 information, which is the basic financial information submitted prior to a company trading publicly, to be released on an FTP server at Knobias's expense and at no cost to the American public, that material and information transparent to the marketplace would be available.

To the extent that the committee finds that of interest that those two organizations would preclude the public from having a basic fundamentally transparent set of facts on which to make an investment decision, I know that is of great concern to us.

Chairman KELLY. Thank you.

Anyone else?

Then we thank you very much.

The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for the members to submit written questions to these witnesses and place their responses in the record.

I thank all of you for your time and your patience and your very interesting comments here today.

This hearing is adjourned.

[Whereupon, at 1:01 p.m., the subcommittee was adjourned.]

A P P E N D I X

September 23, 2004

Statement of Chairwoman Sue Kelly
House Committee on Financial Services
Subcommittee on Oversight and Investigations
"Encouraging Small Business Growth and Access to Capital"
September 23, 2004

This morning the Subcommittee on Oversight and Investigations convenes to continue its review of efforts to encourage small business growth and access to capital.

Small business drives our economy and creates jobs for millions of Americans. In fact, small businesses currently generate nearly three-quarters of the net new jobs per year and employ approximately half of the private sector workforce.

Capital is the lifeblood of small business, and the efficient access to capital is a crucial ingredient to a strong, growing economy. We must ensure that our small businesses have access to capital and that the current regulatory scheme encourages future growth and development.

Available data shows that small businesses are recovering from the downturn in the economy begun in 2001 in no small part due to the easing of their access to capital. Banks began relaxing lending standards in late 2003 for the first time since 1998 and, in turn, demand for small business loans has recently increased. In terms of our equities markets, over 100 companies have undertaken initial public offerings so far this year, making it the best year for new offerings since 2000. Despite these promising numbers, there are still significant regulatory hurdles discouraging small business capital formation.

Last Congress, the Subcommittee on Oversight and Investigations held a hearing entitled "The SEC's role in Capital Formation: Help or Hindrance?". In this hearing, the subcommittee heard from a number of witnesses who contended that the Securities and Exchange Commission (SEC) has simply not kept pace with the needs of small businesses, despite its best efforts.

Since that time, Congress has passed, and the President has signed, important legislation, known as 'Sarbanes-Oxley', to improve auditing standards, disclosure rules and corporate governance. While investors in small companies expect, and deserve, the same protections as those in larger companies, this law places a renewed focus on the need to review the current regulatory framework to ensure that small businesses are able to develop and access capital. There must be concerted effort to modernize our federal securities regulatory framework to ensure we are protecting investors and allowing small businesses to grow.

Today, we will review the steps that our government is taking to address the specific needs of small businesses. In 1996, under the National Securities Markets Improvement Act, Congress was very clear that the SEC ensure "competition, efficiency and capital formation" in its rulemaking. This law also granted the SEC general exemptive authority to ease regulatory burdens and to meet the needs of all businesses – large and small – trying to access the capital markets. Regrettably, the Commission has not been as proactive in exercising this authority to support the needs of small business.

It is time to embrace the advantages that new technology and the Internet have brought to our society and could bring to our government agencies. While the SEC has tried to simplify registration and other regulations for small businesses, these tasks remain extremely daunting for average small business owner. There is a tremendous amount cost and effort that a public company must incur to access the capital markets and comply with federal securities laws. In their pursuit to protect investors, the SEC must also make it a priority to stride for more efficient regulations. The current

regulatory regime must keep pace with the market and the needs of small businesses, otherwise investor protections will also be undermined.

The Commission's inaction has motivated me to draft with my colleague from New York, Representative Nydia Velazquez, the "Increased Capital Access for Growing Business Act" (H.R. 3170). This legislation removes certain obsolete investment limitations on business development companies (BDCs), which were created in 1980 by Congress to encourage investment in small, developing, and financially troubled businesses. By simply modernizing securities laws, this legislation would allow BDCs to provide significant resources to small businesses, as originally intended by Congress.

Since the Commission's position on the legislation has been frustratingly unclear, I urge the SEC to take this opportunity to express their support for this legislation that would have a tremendous impact on the ability of small businesses to access capital. The legislation, which was first introduced last Congress, passed the House unanimously and awaits Senate consideration. After working with the SEC on this legislation for several years, it is time for the Commission to give a public endorsement of this bill and help small businesses by moving the process along in the Senate.

I thank the witnesses for their appearance before the committee to address these important issues. It is my hope that we make progress that will enable small businesses to devote their energies towards their customers and not outdated and inefficient requirements that no longer reflect the realities of our new economy.

TESTIMONY
OF

ALAN L. BELLER, DIRECTOR
DIVISION OF CORPORATION FINANCE
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
SMALL BUSINESS CAPITAL FORMATION

BEFORE THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 23, 2004

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF ALAN L. BELLER
DIRECTOR, DIVISION OF CORPORATION FINANCE
U.S. SECURITIES AND EXCHANGE COMMISSION
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
OF THE
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
REGARDING SMALL BUSINESS CAPITAL FORMATION

SEPTEMBER 23, 2004

Chairwoman Kelly, Ranking Member Gutierrez, and Members of the Subcommittee:

I am pleased to appear before the Subcommittee today on behalf of the Securities and Exchange Commission.

The stated mission of the Securities and Exchange Commission is to protect investors; maintain fair, orderly and efficient markets; and facilitate capital formation. The Commission has long strived to balance its mission to facilitate capital formation with its mission to protect investors. For example, while we consider carefully how our regulatory scheme impacts small businesses, we also believe that investors in small companies deserve a proper level of disclosures and equivalent protections to those of investors in larger companies.[1] In most cases, we believe the two goals complement each other; the public is more likely to invest in our capital markets if they believe that their investments are being protected. The strength and vigor of our markets, including our markets for small business issuers, are unmatched and are ample proof of this very important fact.

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[1] Studies have shown that companies alleged to have been engaged in fraudulent reporting in SEC enforcement cases have often been small, with the overwhelming majority not listed on the New York or American Stock Exchanges. See, e.g., Mark S. Beasley, Joseph V. Carcello, and Dana R. Hermanson, "Fraudulent Financial Reporting: 1987-1997, An Analysis of US Public Companies," Research Commissioned by the Committee of Sponsoring Organizations of the Treadway Commission (March 1999).

SEC Resources for Small Businesses

Our mission to facilitate capital formation requires us to consider carefully how our rules and regulations impact small businesses. In order to ensure that we do this, the SEC has taken a number of steps to focus on small businesses.

Primary among these is the Office of Small Business Policy in the Division of Corporation Finance. This office was created in 1979 to serve as a liaison between the Commission and small businesses. It has evolved in a number of respects in order to respond better to small business issues. Most recently, in 2000, the Office was separated from the Disclosure Operations section of the Division of Corporation Finance to enable it to focus more effectively on general policy issues. The Office directs the Division's small business rulemaking initiatives and interpretations, and comments on SEC rule proposals affecting small companies. It also answers questions received from small businesses by telephone or at its e-mail address, SmallBusiness@sec.gov. Its staff works with Congressional committees, government agencies, and other groups concerned with small business.

The head of the Office of Small Business Policy serves as the Commission's Special Ombudsman for Small Business. The SEC created this position in 1996 to represent the concerns of smaller companies within the entire SEC. The Ombudsman serves as liaison with small businesses about any SEC proposal or rule. He also answers general questions and helps small businesses find answers to specific questions.

The Disclosure Operations section of the Division of Corporation Finance, whose primary role is to review registrant filings, is central to the mission of the Division. Disclosure Operations is divided into 11 groups, 10 of which are organized by industry type. The eleventh

group within Disclosure Operations — the Office of Emerging Growth Companies — reviews substantially all of the initial registration statements of small businesses. After a small business has gone public and filed its first annual report, responsibility for reviewing its filings is generally transferred to the group appropriate to its industry.[2] We feel that the small business expertise that has developed within the Office of Emerging Growth Companies is as important to small business and investors as the industry expertise in the other groups.

In addition to these offices, which serve as resources for small businesses, the Commission has a special page targeted to small businesses on its Web site at www.sec.gov. This page provides access to information especially for small businesses, including the "Q&A: Small Business and the SEC: A guide to help you understand how to raise capital and comply with the federal securities laws." The special small business page also includes links to recent SEC releases, rules and regulations, and other information of interest to small companies.

We also coordinate with other government regulators to discuss issues related to small businesses. In April of this year, we held our annual conference with state securities regulators. The conference is conducted each year in accordance with Section 19(d) of the Securities Act. It brings together federal and state securities regulators to discuss methods of achieving greater uniformity in federal and state securities regulation and maximizing the effectiveness of that regulation. The SEC staff also works closely with the U.S. Small Business Administration and their Office of Advocacy on certain aspects of small business capital formation and other regulatory matters affecting small entities.

[2] Except for so-called "blank check" companies, which continue to be reviewed by the Office of Emerging Growth Companies until they merge with an operating company.

Government-Business Forum on Small Business Capital Formation

Since 1982, under the mandate of the Small Business Investment Incentive Act of 1980, the SEC has sponsored the Government-Business Forum on Small Business Capital Formation. This annual meeting provides the only government-sponsored national forum for small businesses to let government officials from different parts of the federal government know how the laws, rules and regulations impact the ability of small companies to raise capital. This year's Forum was this past Monday, September 20th, at our headquarters in Washington, D.C. The Forum offers an opportunity for representatives of smaller companies to meet with senior government officials and communicate their views on small business capital formation.

The focus of this year's Forum was (1) developments in auditing and their impact on smaller public companies and (2) current challenges to smaller public companies relating to disclosure in SEC filings and corporate governance. There was also a question and answer session with SEC Senior Staff, as well as workshop sessions on issues of particular interest to smaller public companies, venture capital and angel investing, and tax issues. The recommendations coming out of this year's Forum addressed, among other things, the framework for internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002, limits and thresholds of exemptions and rules that accommodate capital formation by smaller companies, and the status of non-registered intermediaries who provide capital formation services to smaller companies. The SEC staff will be studying these recommendations to determine what SEC actions may be appropriate.

The primary recommendation from last year's Forum was that SEC work with the NASD and the National Association of State Securities Administrators (NASAA) to review the role of

"finders" in the capital raising process. The Commission's Division of Market Regulation is currently looking at questions related to how the registration requirement for brokers impacts paid intermediaries, such as finders, who help small businesses raise money. Section 3(a)(4) of the Exchange Act generally defines "broker" as a person in the business of effecting securities transactions for the account of others. Absent an exception, brokers must register with the Commission and a self-regulatory organization such as the NASD, must pass competency exams, and must comply with sales practice rules. The registration requirement also curbs the ability of convicted felons and certain other statutorily prohibited individuals to act as brokers. Some have suggested that the statutory broker registration requirement deprives smaller companies of the services of paid intermediaries that can help them raise capital. The staff in the Division of Market Regulation has discussed this issue with many small business representatives, including a task force associated with the American Bar Association. One important question involves what aspects of the broker registration process or the regulations applicable to brokers are or are not appropriate for paid intermediaries who seek to help small businesses sell securities to investors. Obviously, any actions the Commission takes in this area must be fully consistent with our investor protection mandate.

Regulation for Small Businesses

A number of SEC rules and regulations are specifically tailored to provide accommodations for small businesses that seek to raise capital in the U.S. markets. Some of the accommodations come in the form of exemptions from the general requirement to register public offerings of securities under the Securities Act of 1933. Other rules and exemptions are available to all types of companies that fulfill certain criteria, but their nature makes them especially useful for many small businesses.

One of the exemptions is Regulation A,[3] which provides an exemption from registration requirements for non-reporting U.S. and Canadian companies issuing up to $5 million in any 12-month period. Offerings under Regulation A share many characteristics with registered offerings, but have certain advantages for issuers over full registration. Principal among these advantages are: (1) the financial statements are simpler and do not need to be audited; (2) there are no continuing reporting obligations after the offering unless the company has more than $10 million in total assets and more than 500 shareholders; (3) companies may choose among three formats to prepare the offering circular, one of which is a simplified question-and-answer document; and (4) companies may "test the waters" to determine if there is adequate interest in their securities before going through the expense of filing with the SEC. We have received suggestions, including from the 2003 Government-Business Forum, to increase the amount of capital a company could raise under Regulation A. The staff is considering whether it should recommend that the Commission raise this cap consistent with its investor protection mandate, as well as whether larger offerings should trigger additional conditions to the exemption.

The Commission's Regulation D[4] exempts certain transactions from registration under three separate rules, each of which reflects a Commission determination that registration and prospectus delivery should not be required for offers and sales that meet certain criteria. The exemptions in Regulation D most often used by small businesses are in Rules 504 and 506.

Rule 504 exempts offerings of up to $1 million per 12-month period; this exemption allows for the issuance of freely traded securities only if the company files an offering document with a state having review and prospectus delivery requirements or sells under a state law

[3] 17 C.F.R. § 230.251-263.

[4] 17 C.F.R. § 230.501-508.

exemption that limits sales to "accredited investors."[5] In 1999, the Commission revised Rule 504, which had allowed all securities issued under Rule 504 to be freely traded, in order to curb fraudulent secondary transactions in the over-the-counter markets of "microcap" companies. As I described, the current version of Rule 504 provides that only securities that are issued in accordance with state law can be freely traded after issuance. All other issuances under Rule 504 result in restricted securities that may not be freely offered or sold to the public. During this Subcommittee's June 2001 hearing on the SEC's role in capital formation, some witnesses suggested that we could better facilitate capital formation for small businesses if we reverted to the pre-1999 version of Rule 504. The Commission determined in 1999 that significant fraud was occurring following the use of Rule 504, and I believe it would have to be convinced that those abuses would not be repeated before rolling back those changes.

Rule 506 is a "safe harbor" and is available to all companies. It permits sales to accredited investors and to a limited number of non-accredited investors. All non-accredited investors to whom a Rule 506 offering is sold must be sophisticated — that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment. We have received suggestions, again including from the 2003 Government-Business Forum, to eliminate or loosen the restrictions on the use of general solicitation of investors, over the Internet or otherwise, using

[5] An "accredited investor" is: (1) a bank, insurance company, registered investment company, business development company, or small business investment company; (2) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million; (3) a charitable organization, corporation or partnership with assets exceeding $5 million; (4) a director, executive officer, or general partner of the company selling the securities; (5) a business in which all the equity owners are accredited investors; (6) a natural person with a net worth of at least $1 million; (7) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or (8) a trust with assets of at least $5 million, not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person. See 17 C.F.R. § 230.501.

Rule 506. The staff is considering these recommendations in the overall context of the Commission's investor protection mandate.

The SEC's Rule 701 exempts from registration sales of securities made by companies that are not subject to Exchange Act reporting requirements to compensate their employees. Such companies can issue up to $1 million under this exemption, and that amount may increase if a company satisfies certain formulas based on assets or on the number of its outstanding securities. If a company sells more than $5 million in securities in a 12-month period, it must provide limited disclosure to employees. Employees receive restricted securities in offerings made under Rule 701.

In addition to the exemptions in Regulation A, Regulation D and Rule 701, there are other rules, regulations and forms for small business issuers that do register and report with us. For example, small business issuers offering up to $10 million worth of securities in a 12-month period may use Form SB-1 to register its securities, if they have not registered more than $10 million in any previous 12-month period. This form allows small issuers to provide information in a question and answer format, similar to that used in Regulation A offerings. Unlike offerings under Regulation A, however, Form SB-1 requires audited financial statements.

A small business issuer may register an unlimited dollar amount of securities using Form SB-2, and may use this form for registering securities so long as it satisfies the "small business issuer"[6] definition. One advantage of Form SB-2 is that all its disclosure requirements are in Regulation S-B, a set of rules written specifically for small businesses. Form SB-2 also permits

[6] "Small Business Issuers" are U.S. or Canadian companies, other than investment companies, with less than $25 million in revenues and less than $25 million in market capitalization. If the company is a majority owned subsidiary, the parent corporation must also be a small business issuer. See 17 C.F.R. § 228.10(a)(1).

small companies: (1) to provide audited financial statements, prepared according to generally accepted accounting principles, for two fiscal years, rather the three years required of larger companies, and (2) to include less extensive narrative disclosure than larger companies are required to include, particularly regarding the description of business, and executive compensation.

Qualifying small business issuers can also use specially tailored forms for their annual and quarterly reports, the content of which is governed by Regulation S-B.

Sarbanes-Oxley Act of 2002

One issue that small businesses consistently raise with us is compliance costs for the requirements put in place by the Sarbanes-Oxley Act of 2002. While the Act did not make any distinctions based on company size, in implementing our rules under the Act, we tried very hard to be sensitive to the concerns of small business issuers, and we made a number of accommodations for them. For example:

- We gave small business issuers extra time to comply with the rule requiring disclosure of whether they have a financial expert on their audit committees.
- We gave public companies with less than $75 million in market capitalization additional time to comply with the rules requiring a report on internal control over financial reporting. As a result, this requirement will apply for the first time to most small business issuers for filings they make in 2006.
- In the adopting release for the internal control rules, and again in recent staff guidance on Frequently Asked Questions (or FAQs) about the rules published on our Web site, the

Commission and the staff have encouraged the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, or a similar group, to develop guidance that can help address the special concerns of small businesses by providing a more tailored framework for internal controls.

- Small auditing firms with fewer than five public-company audit clients and ten partners are exempt from the audit partner rotation requirements and the prohibitions on compensation based on providing non-audit services to public company clients.

Despite these accommodations, the cost of Sarbanes-Oxley compliance continues to be a source of concern for small companies. We also have heard anecdotal evidence that some smaller public companies may forego their public reporting status rather than comply with the new Sarbanes-Oxley governance requirements. Although our rulemaking under Sarbanes-Oxley has been completed, we continue to consider the impact of recent rules on small businesses, while recognizing that good corporate governance and financial reporting are important for all companies, regardless of size.

Other Initiatives Benefiting Small Businesses

In addition to the rules and regulations I've discussed already, there are a number of other recent initiatives that the Commission has undertaken, or is considering, that provide accommodations or can benefit small companies.

Rulemaking. The Commission has made a number of other accommodations for small companies in certain of our rules, other than those discussed above under Sarbanes-Oxley, that we implemented during the same period. For example,

- Public companies with less than $75 million in market capitalization are exempt from the new accelerated deadlines adopted in September 2002 for quarterly and annual reports.
- Small business issuers are not required to include in their periodic reports the table of contractual obligations that is required for other issuers under rules adopted in January 2003.

Use of Technology. During this Subcommittee's June 2001 hearing, some witnesses suggested that we could better facilitate capital formation for small businesses by allowing increased use of the Internet for offerings and reporting requirements. The technological developments of the last decade, including the Internet, present numerous opportunities and benefits for companies and investors, but they also present significant challenges for regulators, such as the SEC, that are charged with protecting investors. The Commission has been striving to maintain the important protections of our rules, without stifling the potential of the Internet and other emerging technologies in the capital formation process. For example, since the Commission's 2000 Interpretive Guidance on the Use of the Electronic Media[7] was issued, the staff has worked with issuers who want to issue all-electronic registered offerings. The use of the Internet in exempt private offerings continues to be a source of concern to us, however, for reasons of investor protection.

The Commission also has increasingly acknowledged and seeks to foster, with necessary protections, the wide accessibility of information on company Web pages when drafting regulations. In its recent rule requiring companies to file earnings announcements, the Commission included a specific exemption for presentations made by Web cast, if, among other

[7] Exchange Act Release No. 42728 (April 28, 2000).

things, they are available on the company's Web site. Moreover, in implementing Section 406 of Sarbanes-Oxley regarding codes of ethics, the Commission specified that the requirement that companies make a copy of their codes of ethics available to the public can be satisfied by posting on the company's Web site. We continue looking for ways to appropriately use technology to benefit companies and investors alike. For example, the Staff currently is considering recommending to the Commission that it require electronic filing of Form D, which gives notice of the sale of unregistered securities (such as those sold under a Regulation D exemption).

Securities Act Reform. Since the mid-1990s, and indeed in some sense since the mid-1980s, the Commission and the Division of Corporation Finance have sought to modernize the Securities Act registration process in a sensible way. The Division is working to devise a set of proposals to recommend to the Commission that will modernize our principal areas of regulation in the registration process, as well as in a number of incidental and ancillary areas. While some of these reforms will be primarily aimed at large seasoned issuers, we believe that small business issuers also can benefit from the general modernization of the offering process. The issues and possible approaches we are considering are all at a somewhat preliminary stage, and of course any proposal will depend on the views of the Commission.

Staff Review Process. At this Subcommittee's June 2001 hearing, some witnesses expressed concern about the timing and priorities of the Division of Corporation Finance's review process as it related to small companies. As you are all aware, since that hearing Section 408 of Sarbanes-Oxley recognized the importance of the review process and now requires the Division to review issuers' filings at least once every three years. This mandate has been the catalyst for a substantial amount of hiring in the Division, as well as a reexamination of our review priorities. While we have focused a good deal of attention on larger issuers, our evolving

ability to identify particular characteristics that may merit review of companies of whatever size is intended to provide better and more focused reviews. The Chairman has made it a top priority to develop a risk management initiative — the first of its kind at the Commission — that will better enable the Commission to anticipate, identify, and manage emerging risks and market trends that stand to threaten the Commission's ability to fulfill its mission. The new initiative is being coordinated by a newly created Commission Office of Risk Assessment, complemented by a Risk Management Committee and assessment professionals on staff in each Division and major Office. Better risk assessment, including through use of technology, we believe will assist us in making decisions about what to review and what comments to raise with issuers. The Division also will be forming an Office of Disclosure Standards that will have responsibility for evaluating the Division's review policies and review results.

Short Selling. During this Subcommittee's June 2001 hearings, some witnesses raised concerns about the impact of short selling on small businesses. Over the past few years, the Commission and self-regulatory organizations have been focusing on short sale regulation. In the most recent significant action, on June 23, 2004, the Commission adopted Regulation SHO and amended other rules governing short selling to address abusive naked short selling. Regulation SHO requires broker-dealers who are not engaged in bona-fide market making to locate securities available for borrowing prior to effecting a short sale in any equity security. Regulation SHO also creates a mandatory delivery requirement for short sales of threshold securities[8]

Business Development Companies. As you know, in 1980, Congress amended the Investment Company Act of 1940 to establish business development companies, or BDCs.

BDCs are a type of closed-end investment company that are required by law to be operated for the purpose of making capital more readily available to small, developing and financially troubled businesses. Reflecting that purpose, BDCs must invest a significant portion of their assets in businesses that are "eligible portfolio companies," as that term in defined in the Investment Company Act. Among the businesses that fall in that definition are businesses that do not have any classes of securities that are marginable under the rules of the Federal Reserve Board. Changes to the Federal Reserve Board's margin rules have made most securities marginable. Consequently, many of the issuers that used to be eligible portfolio companies no longer meet that definition, which has reduced the flow of BDC capital to those businesses.

The Commission's Division of Investment Management is working to see if there is anything the Commission can do to address this issue, but certainly Chairwoman Kelly must be acknowledged for her leadership role in Congress in seeking to reestablish BDCs as a source of capital for small businesses.

Conclusion

I thank you for the opportunity to be here today. The SEC has long considered small businesses to be an important part of our regulatory responsibilities. We have looked, and are continuing to look, for ways to fulfill accommodate small businesses in the fulfilling our dual mission of protecting investors and facilitating capital formation. I would be happy to answer any questions you may have about our program.

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[8] Equity securities that have a significant number of aggregate delivery failures at a registered clearing agency.

Testimony of James A Connolly III representing the CEO Council before the Subcommittee of Oversight and Investigations of the House Committee on Financial Services

September 23, 2004

Good morning Chairwoman Kelly and members of the Subcommittee. First, allow me to thank you for the opportunity to appear before you to present a somewhat different perspective on small business capitalization as experienced by the over 7000 publicly traded companies currently listed on either the OTCBB or the Pink Sheets. We are gratified that our efforts to communicate with the Congress and the relevant Federal agencies, under your leadership as advocates for small business, result in my appearance here today.

My name is James Andrew Connolly III. I am a native New Yorker and am here as a founding member of the CEO Council, a Maryland chartered 501c6 organization of small public company executives, with both a growing network of local chapters and an expanding membership base throughout the country. Our stated purpose is to enhance the public markets for investors and couple this with affordable financing options for smaller public companies. We are seeking to achieve these goals with both a member driven advocacy effort along with supplementing the information available to the markets as to the opportunities open to investment in these "engines of economic growth, job creation and innovation." Our market space of 7000 companies includes hundreds of million of dollars in market capitalization, tens of thousands of employees, and likely hundreds of thousands of stockholders. We are the "dirty" little secret of the securities markets, much maligned, over regulated and often referred to as "penny stocks" in the same sentence as "scam".

I can state with certainty that the perception of fraud is not the same as fraud, and the substantial majority of these companies are operated in an ethical and businesslike manner. They are responsive to their customers, good employers and contributors to their communities along the way. They operate in all 50 states and probably in most Congressional districts. They range from start-ups to well-seasoned enterprises who all share the competitive challenges of a global marketplace, a recovering economy and the burden of often unaffordable compliance costs.

It is frequently the case when apportioning resources that a microcap CEO is compelled to choose between expanded reporting costs and new hiring, payroll and benefits or audits and expanded legal advice. Public transparency costs whether as traditional investor relations or fully compliant research dissemination; director indemnification or liability coverage, without which many of these companies cannot attract qualified outside directors compete for scarce corporate resources and are therefore often lacking. Heretofore our microcap colleagues have had to compete without being able to collectively represent their interests as significant contributors to

the economic well being of The United States – not to mention often very good investments without running the gauntlet of regulatory indifference at best and outright hostility to our continued existence at worst. This has not occurred in a vacuum; there clearly have been many instances of abuse, we hear of them in the press when advised to avoid "penny stock" investments and unfortunately with regular and necessary enforcement actions that become highly publicized. Taken cumulatively these facts explain both the virtual impossibility of obtaining either startup or expansion capital on terms that are rational, as well as diminished liquidity in secondary trading.

Undoubtedly modern era of instant execution, online trading and affordable transaction costs, combined with the relative lack of substantive reliable data on many microcap securities has led to an overall lack of transparency, and created multiple opportunities for both fraud and market manipulation. The CEO Council was formed with these challenges in mind and has worked deliberatively over the past 3 years to effect what we hope are progressive changes.

We took an early and active role in opposing the BBX as envisioned by Nasdaq. They like all profit motivated organizations hoped to escape the costs of regulating the OTCBB without provision for the thousands of companies who either would not, could not or chose not to list thereby relegating them to Pink Sheet status which demonstrably would lead to a major loss of market capitalization and reduced investor liquidity.

The Council has maintained an active presence at the annual "Government Business Forum on Small Business Capital Formation" held every year since Congress mandated it in 1980. We have contributed to its agenda and suggested several of the hundreds of recommendations that small business owners, regulators and industry practitioners have suggested for implementation. Sadly, far too few have been adopted or implemented. It often seems that that the various divisions of the SEC are in conflict with each other when responding to our concerns. The perception of Enforcement appears to be guilty until examined innocent, Corporate Finance clearly has a Fortune 1000 focus and it is left to the Small Business Ombudsman, Mr. LaPorte to represent our interests within the bureaucracy – often to no avail. I have included with my written testimony for the Subcommittee's review the recommendations from 2002 and 2003.

The NASD has had some significant negative effects on our marketplace as well. In their determination to disallow broker/dealers to receive ANY compensation for filing form 15c211 despite substantial costs to fully due diligence a listing the 200+ market makers in Pink Sheet listed companies shrink to 40 active submitters creating less than a fully open and competitive marketplace. If the attorneys and accountants have no problem being paid for rendering professional services are fully registered, licensed market makers who, through their due diligence prior to filing, are the first line of defense against fraud any less deserving?

Time does not permit me to cite many other obstacles microcap companies encounter in a full discussion here today, but with your indulgence I will cite 3 other significant proposals that the CEO Council would recommend. Firstly I am aware that there is interest at both the American

Stock Exchange in New York, and the Pacific Coast Exchange in San Fransisco in the development of a specialist based "new venture" or "microcap" exchange. This should be fully explored at both the SEC and the NASD as its potential for small company access to capital is very promising.

Secondly we would like to propose a new regulatory regime for Small Business Issuers. This might include consultative roles for organized participation by ALL elements of the capital markets with investor advocates, institutional investors, regulators issuers and other interested parties operating in a framework to create what some have called the "Enterprise Exchange". There are opposing views on whether a specialist or dealer market is a better solution, but we believe this is worth exploring.

Finally we believe that regulation 15c211 should be improved and streamlined. Such that non-reporting issuers should provide financial information to the marketplace and that Reg 15c211 should be right sized to fit this goal. Additionally, despite multiple efforts some with Congressional support the information on this form which could form the basis of informed investor interest is maintained by the NASD and has been refused by them to be fully disseminated to the public as filed. There are data vendors who would gladly supply this information, several free of charge as transparency we all agree is a paramount goal.

Investor protection and Small Business capitalization need not be mutually exclusive and hopefully this dialog today will add to the efforts expended by many of us who are deeply concerned that without both regulatory changes and a more fully informed investor base though increases in financial literacy coupled with enhanced disclosures, the microcap marketplace can once again thrive and be a hotbed of innovation and growth for our economy.

Thank you for hearing our concerns today as well as your willingness to address them. I know the members of the CEO Council are pleased to be a resource. We hope you will call on us in your future efforts to keep our markets the most efficient and transparent in the world.

We would like to add to the record in the allotted time with your permission Chairwoman Kelly.

Testimony of

America's Community Bankers

On

Encouraging Small Business Growth and Access To Capital

before the

Subcommittee on Oversight and Investigations

of the

Financial Services Committee

of the

United States House of Representatives

on

September 23, 2004

Thomas Schneider
President and CEO
Pathfinder Bank
Oswego, NY

Good morning Chairwoman Kelly, Ranking Member Gutierrez and members of the Oversight and Investigations Subcommittee. Thank you for inviting me to testify today on Small Business' Access to Capital. I am Tom Schneider, and I am President and CEO of Pathfinder Bank located in Oswego, NY. Pathfinder Bank is a $300 million dollar community bank that is the primary subsidiary of Pathfinder Bancorp, a mutual holding company. About one-third of the holding company shares are held by public investors and we are traded on NASDAQ. I am here representing America's Community Bankers. ACB is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities.

Small Business Climate

I am proud to report that the climate for small businesses in my community is excellent. As all of you are aware, small businesses are the economic engine in our country. They are our job creators and also vital customers for my bank. Small businesses are growing and creating much-needed jobs, often because community banks across our nation are focusing on helping local businesses with their capital needs. In addition, today's low interest rate environment is helping small businesses, and the benefits of low interest rates are transmitted directly through community banks.

Since my bank is located, using the old term for the region, in the "Rust Belt," we have experienced a large transition over the years. Oswego, New York, is located in the old manufacturing heart of our nation. As the U.S. economy has shifted from a manufacturing oriented economy to one that is service oriented, our community has had to adapt. Pathfinder Bank has been proud to provide capital to aid that transition. The American entrepreneurial spirit is alive, and thriving, in my community. I strongly believe that because of my bank's relationship with the people and the small businesses in our community, we have been able to help fuel new economic growth and provide new jobs for the people of Oswego.

Being a community bank is not just a title or an image. It is a belief, a commitment to helping our communities and helping our small businesses with their capital needs, so they can continue to grow and succeed.

Types of Capital Available for Small Businesses

Whether an entrepreneur is starting a business or wants to grow an existing business, there are three types of capital that is available. 1) Equity financing, 2) debt financing, and 3) the businessperson's own capital. In many instances, they rely on friends and family for the capital.

Equity financing is done primarily by angel investors, or in rare cases, venture capitalists and investment banks. The unfortunate truth is that for many small, start-up businesses, equity capital is hard to find. If an entrepreneur with a dream and a work ethic, but little capital wants to start a small business, he or she will most likely not be able to find equity financing. That is why community banks are so valuable for economic growth in our nation. Not only do we provide needed resources to help existing businesses grow and innovate, by lending on other collateral with supplemental guarantees, we provide the startup funds for businesses.

Community Banking for Small Businesses

When it comes to debt financing, the primary sources are community banks and large institutional banks.

My bank proudly offers several types of financial products that can meet the capital needs of the small businesses in the Oswego area. For example, we offer lines of credit, conventional loans, loans for equipment and machinery, and traditional banking services.

One of the greatest tools we have for aiding small businesses is one of the U.S. Government's best private/public partnerships ever created by you, the Congress: the programs of the Small Business Administration (SBA).

Because of the inherent risk posed by small businesses, banks need help in sharing the risk posed by small business loans. The SBA is an excellent partner in carrying out the mission of providing capital to small businesses. The SBA has two primary programs that are used by community banks: the 7(a) loan program, and the 504 loan program. These guarantee programs allow community banks, such as Pathfinder Bank, the opportunity to provide capital to small businesses that would not otherwise qualify for credit.

Although we offer numerous financial products to small businesses in our community, there is one attribute that is even more important. Community banks offer access to the decision-maker, and they know the people and the area. Because of this working knowledge, community bankers are vital for small businesses since they know and understand their unique needs, and therefore are often more flexible in their decision making. Ours is not a one-size-fits all society. Small businesses have a variety of needs and characteristics that cannot be realized by a bank officer sitting in a big city reviewing loan documents. Often times, making a loan decision will come down to the character and integrity of the person applying. As a community banker I know the people of my community and can make that decision. Someone reading the printout from an online application can never do that. One of the real advantages community banks like mine have, is the fact that we are not just a website to a mega-bank.

One example of this is the community hospital in Oswego. A few years ago the hospital needed capital to renovate and expand the services it provides our community. It tried working through a large institutional bank, but did not meet the cookie cutter criteria for the bank to approve the loan. The hospital faced the prospect of not receiving the funds it needed to continue providing high quality service to the people of Oswego. Luckily, Pathfinder Bank knew the hospital and the good people running it. Working with another community bank we were able to serve the people of Oswego by providing the needed financing for the hospital.

The Impact of Sarbanes-Oxley on Community Banks

Sarbanes-Oxley has had an impact on how small, publicly traded banks such as Pathfinder do business. Ultimately the legislation will make our economy stronger by increasing corporate accountability and providing greater confidence for investors. However, small banks such as

mine are often seeing large cost increases in the short run. What might be of interest to the members of the subcommittee is that just over a year ago, ACB conducted a survey of 30 of our New York Stock Exchange and NASDAQ listed members on the impact of the Sarbanes-Oxley Act of 2002. Most responders to the survey said that the biggest impact of Sarbanes-Oxley appears to be the fees paid to board and audit committee members, and to auditors and other third parties.

Overall, ACB's survey indicated that Sarbanes-Oxley is important to reeling in the conduct of bad corporate lawyers and accountants. However, we also feel that some of the law's provisions are unnecessary for the banking industry since we are so well regulated and supervised. In addition, we believe parts of the law are particularly burdensome on the smaller community banks. The costs and fees, as well as the stress on staff associated with complying with Sarbanes-Oxley, may justify allowing smaller organizations to be exempt from portions of the law.

In addition, ACB and its members support efforts to see if there are requirements that can be streamlined or waived by the Securities and Exchange Commission to facilitate greater access to the capital markets for small businesses. While many of the existing regulations may be necessary for larger and more complex companies, they may be an unnecessary obstacle to the capital markets for smaller businesses.

Capital for Community Banks

Pathfinder Bank is a publicly-traded company with emphasis on providing banking and financial services to our local community. We issued stock in order to have the capital to further our mission of helping local businesses grow. Becoming publicly-traded provided us with capital that allows us to make more loans to small businesses in our community. Without the additional funding, we would have to write fewer small business loans. In terms of growing a business, we were like any other. We had to seek capital so we could further expand our services and product lines, and more importantly, to hire additional employees. Assisting community banks in accessing the capital markets benefits our communities and especially small businesses by providing community banks with the capital to help fuel economic growth. That is why I applaud the Subcommittee for holding this hearing today to see how we can improve the access to capital for small businesses. Small banks are in the unique position of both providing capital and acquiring capital. If rules or laws can be simplified and streamlined so as to provide greater capital to small banks, it benefits our entire nation.

I am proud to bring to the Subcommittee's attention an effort to bring greater attention and capital to community banks. In partnership with NASDAQ, ACB created the America's Community Bankers NASDAQ Index comprised of the stock prices of over 500 community banks. The ACB NASDAQ index focuses attention on community banks as a vital sector of the financial services industry and our nation's economy. The index provides a new tool for tracking the performance of our strong community-based banking sector. It will bring greater visibility to community banking, which should yield greater liquidity and fairer valuations to our banks, thrifts and holding companies. It will measure where the nation's economic action is taking place - in local communities across this country.

ACB and NASDAQ developed the index as a yardstick for the capital markets to use in measuring the performance of community bank stocks. As of July 31, 2004, the index included 518 NASDAQ-listed community banks, with a market capitalization of about $175 billion,

Conclusion

In conclusion, Pathfinder Bank and ACB, believe there is a prosperous climate for Americans to start and grow a small business. Community banks across our great country are willing and able to meet the capital needs of small businesses.

Chairwoman Kelly, Ranking Member Gutierrez and members of the Oversight and Investigations Subcommittee, thank you again for allowing me to testify. I am available to answer any questions you may have.

Testimony by Frank Speight,
Founder, Chairman and CEO
American Capital Partners Limited Inc. (BDC)
and
Cochairman, National Small Public Company Leadership Council
before the
Subcommittee on Oversight and Investigations
of the
House Financial Services Committee
U.S. House of Representatives

September 23, 2004

Good morning, Madame Chairwoman and Members of the Subcommittee. Thank you for the opportunity to appear before you today to testify on the issue of small business access to capital.

I am Frank Speight. I am the Founder, Chairman and CEO of American Capital Partners Limited, a registered Business Development Company, which is based in West Palm Beach, Florida. I also serve as Cochairman of the National Small Public Company Leadership Council, a Washington, D.C.-based group that seeks to educate and inform the White House, Congress and Federal agencies about the issues impacting the nation's small publicly traded companies and the economic contributions they are making.

Let me first congratulate Chairwoman Sue Kelly on the House passage of the Kelly Bill called Increased Capital Access for Growing Businesses Act (H.R. 3170) that would modernize outdated securities laws to ensure that small businesses have better access to capital through Business Development Companies, or BDCs. I have enjoyed working with Congresswoman Kelly on behalf of the Leadership Council. And it is exciting for me to see the first fruits of her efforts to broaden access to capital for BDCs, which are publicly traded investment companies that invest in both public and private companies and generate an injection of capital for businesses.

I am here today in support of her efforts and to urge that access to capital be broadened to encompass all small and developing companies. Small business is the engine of the economy. The ability of small business to raise funds and have access to loans or to the capital market is essential. When small businesses don't have the capital they need they are unable to make the investments they require to grow. And this, in turn, hampers growth in the overall economy. We must do all we can to create a greater access to the capital markets for small business.

An important step in providing greater access to the capital markets for small public companies can be taken by reinstating a modified version of the SEC Rule 504 Exemption, which was among the reforms created by the Reagan administration. For small businesses, in particular, the paperwork and legal costs are prohibitive for raising money through the capital markets. The Reagan administration's SEC Rule 504 made it easier for small firms to raise money from the stock market by exempting them from many SEC regulations if they raised one million dollars or less over a year.

To briefly review, the results of Reagan's SEC reforms were immediate. Small businesses fueled the boom of the 1980s and 1990s. Small businesses quickly realized that they could raise capital as never before, and the sector became the engine of growth for the new economy. For example, in 1984 two friends who owned a small ice-cream shop in Vermont wanted to build a full-fledged manufacturing plant to sell their product nationally. The friends decided to bypass an underwriter or a broker and raised $750,000 by selling directly to Vermont residents. A year after raising this seed capital, Ben & Jerry's listed on the NASDAQ and soon became one of the best-selling brands in the U.S.

According to a report in The New York Times in 1983, the SEC's changes under the Reagan administration had brought an additional $500 million into the markets in less than two years. Also, as Philip Koslow wrote in his book, The Securities and Exchange Commission, published in 1990: "The SEC's new approach undoubtedly contributed to the expansion of the markets and the growth of new capital. Wall Street, which had seen some hard times since the 1970 slump, began to boom. New buildings were going up throughout the financial district in lower Manhattan, and firms were hiring thousands of new workers. Suddenly Wall Street was the place to be for the energetic and ambitious. ....All this activity clearly bolstered the economy in the short run."

During the early 1990s the reforms of Rule 504 were liberalized and once again small businesses fueled the boom. According to the Small Business Administration, more than one-half of all U.S. employees work for companies with 500 employees or less. These firms produce 47 percent of all business receipts and nearly all the new job growth. Firms with more than 500 employees actually had a net decrease of jobs from 1992 to 1996. Some economists credit small business for the dramatic growth in American productivity that was responsible for the prosperity of the 1990s.

But since that era the SEC has found excuses to roll back the reform policy that Reagan had put into place. During its reign, Rule 504 successfully proved to build prosperity by giving small companies more access to the capital markets.

The SEC would argue that Rule 504 still exists on the books today. But in reality, the SEC has taken the teeth out of the measure and it is of little use. Under the former 504 guidelines accredited investors could receive unrestricted securities for their investment, thus allowing them the necessary liquidity to lessen their risk exposure. It also allowed them the opportunity to more quickly reinvest the proceeds from an investment into another small public company.

There's a tremendous need to modernize outdated securities laws to ensure that small businesses have better access to capital.

My recommendation is the reinstatement of SEC Rule 504 to its former parameters but with several modifications. These changes would be to:

- Increase the annual cap on the money small businesses can raise to two million dollars, from the former one million dollars. This would allow small micro cap public companies the access to the levels of capital they truly need.
- Require the SEC to develop some kind of mechanism to streamline the process for the filing. If a small public company is current in its SEC filings they should be allowed to file an easy 504 "notification filing," with supporting documentation such a legal opinion, on EDGAR similar to the current S-8 filing in place to compensate Consultants.

Madame Chairwoman and Members of the Subcommittee, small businesses are the backbone of our economy. It is critical for small businesses of all kinds to have more access to capital in order to create new jobs and ensure a strong, growing economy.

Thank you, Madame Chairwoman.

TESTIMONY OF

JOAN SWEENEY

CHIEF OPERATING OFFICER,

ALLIED CAPITAL CORPORATION

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATION
OF THE
COMMITTEE ON FINANCIAL SERVICES

September 23, 2004

STATEMENT OF JOAN SWEENEY

Madam Chairwoman, members of the Subcommittee, I am Joan Sweeney, the Chief Operating Officer of Allied Capital Corporation. Our business is investing in the American entrepreneurial economy, and we are the nation's largest Business Development Company or BDC. Thank you for the opportunity to discuss the essential role that BDCs play in providing growth capital and expertise to smaller businesses. I also want to thank you, Madam Chairwoman, and Congresswoman Velasquez for your efforts in passing H.R. 3170, the "Increased Capital Access for Growing Business Act." If enacted, this important piece of legislation will increase the number of U.S. companies that could access capital from BDCs. This legislation has not yet moved through the Senate, and we understand that the SEC is now undertaking rulemaking initiatives concerning the definition of eligible portfolio company, which is so appropriately addressed by H.R. 3170.

Allied Capital has been investing in small and growing businesses for 46 years, and over that time we have provided financing to thousands of American small businesses. Our assets today are over $3 billion, and we have investments in 116 portfolio companies, which generate aggregate annual revenues of approximately $11 billion and employ more than 105,000 people.

We provide both mezzanine debt and equity capital, which is used for growth, buyouts and recapitalizations. We believe that smaller companies need additional financing sources. The U.S. financial services industry has been contracting as a result of broad-based consolidation. This trend has reduced the amount of debt capital available to smaller companies. In addition, the cost of being a public company and accessing the markets in a post-Sarbanes-Oxley world is

higher than ever. Going public has become less attractive, and more companies are seeking private financing options.

Small public companies, however, cannot turn to a BDC as a private financing source, because, under current law, they are not eligible. This is unfortunate because BDCs, as regulated entities, provide transparency as to their investing activities and are a natural match for smaller companies. Deprived of this option, many small public companies, desperate for capital, have instead sought private financing from private equity and hedge funds, which provide private investment in public equities, or "PIPE," financing. These unregulated funds have little transparency as to their activities, and may not have the best interests of the small company in mind. Some have even structured "death spiral" PIPEs where the fund intends to profit from the fall of the small firm's stock price.

Congress recognized the need for alternative sources of financing for smaller companies in 1980 when it created BDCs. In defining the types of businesses eligible for BDC financing, Congress set the definition of an "eligible portfolio company" as a company that did not have a class of marginable securities under the rules of the Federal Reserve. According to the legislative history, Congress intended the pool of eligible portfolio companies to be "very broad," and it was estimated that 8,000 of the12,000 publicly traded companies at the time would be eligible.

However, in 1999 the Federal Reserve greatly expanded the definition of marginable securities. Today, any security listed on the Nasdaq Stock Market is considered marginable, which is a substantial shift from what was marginable in 1980. The Federal Reserve's changing view of marginability collided with Congressional intent for BDCs and drastically reduced the universe of companies eligible for BDC financing. Small public companies needing cash for

growth are no longer eligible, and recently questions have been raised about the eligibility of private companies with outstanding debt securities, since debt securities are also now marginable. BDCs are permitted to invest a limited amount of capital in companies that are not eligible portfolio companies, but there should be no limit when it comes to providing growth and expansion capital for smaller companies.

Let me give you one example of an investment Allied Capital made in a small public company. Blue Rhino, which you may recognize as the provider of the propane gas cylinder that powers your outdoor grill, came to us in 2001 for $15 million in financing. Their stock was trading at only $3.70 per share and their market capitalization was less than $100 million. This company was not a candidate for a secondary public offering. Our financing enabled the company to grow its sales substantially in 2001 and 2002. The company increased in value, its shareholders benefited, and Allied Capital's shareholders benefited with a capital gain.

BDCs work well. They are regulated, and provide significant disclosure. BDCs can play a more meaningful role in providing capital to entrepreneurial companies if the definition of eligible portfolio company is updated to be consistent with what Congress intended in 1980.

We encourage the Subcommittee to review the rule-making activity of the SEC to ensure that the definition is appropriately amended both to restore Congress's original vision and to provide consistency with the provisions of H.R. 3170.

Thank you for the opportunity to testify today.

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