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# EXAMINING INVESTOR RISKS IN CAPITAL RAISING

## HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING INVESTOR RISKS IN CAPITAL RAISING

DECEMBER 14, 2011

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# EXAMINING INVESTOR RISKS IN CAPITAL RAISING

**WEDNESDAY, DECEMBER 14, 2011**

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Subcommittee met at 9:34 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, Chairman of the Subcommittee, presiding.

## OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. I want to call the hearing to order. I want to welcome everyone to this hearing on "Examining Investor Risk in Capital Raising." I want to thank my Ranking Member, Senator Crapo, for his participation and his support not just in this hearing but throughout this legislative session.

The capital markets today play a vital role in the United States economy, providing capital to small and large companies to fund the search for new ideas, to develop new products, and ultimately, and very importantly, the hiring of new workers. Spurring the growth of American business and job creation is an important aspect of this Banking Committee and our responsibilities.

The recent financial crisis has had a devastating effect on our economy. With a fragile economy and continued high unemployment, directing the flow of capital to enterprises that will improve the economy and put people to work is vitally important. However, we must not forget that gaps in regulation and transparency contributed to the enormous losses caused by the financial crisis.

Earlier this year, Mary Schapiro, the Chairman of the Securities and Exchange Commission, announced that the SEC was taking a fresh look at the rules for companies raising capital from investors. Chairman Schapiro also formed the Advisory Committee on Small and Emerging Companies in September to look for ways to make capital formation for small and emerging companies more efficient and effective.

In January, the Administration formed Startup America to inspire high-growth entrepreneurship throughout the Nation.

In March the Treasury Department held an Access to Capital Conference which led to the formation of the independent IPO Task Force. The task force report was released in October and will be part of our discussion today.

In addition to these initiatives, a number of bills have also been introduced that seek to improve the flow of capital from investors to businesses. Some of the proposals focus on reducing costs, others focus on eliminating regulations, and some on creating new paradigms for raising funds.

As we seek to improve job growth by examining how to improve the process of raising capital, we also, however, need to improve the process for protecting investors. Unfortunately, fraud and deception exist in our securities markets, and we have to take effective steps to minimize both of those unfortunate aspects of the securities markets.

Clearly, investors face certain risks when contributing capital to either small or large companies. Will the investment lose money? Can the securities be sold immediately or is there a holding period? Are the investments suitable? If the company does well, will the investor get the share of the profits? Or will the investors be left out of the profits because the company left them behind in favor of new investors? These are all vital questions that we hope to address today.

Today's hearing will examine different proposals to update and streamline and our capital-raising process. We will focus on how we can best protect investors and on finding an appropriate balance between improving the ability of small and large companies to access capital and providing modern and updated investor protections. I look forward to our witnesses' testimony this morning on all of these important topics.

Now I will recognize Senator Crapo.

**STATEMENT OF SENATOR MIKE CRAPO**

Senator CRAPO. Thank you very much, Mr. Chairman. I appreciate your holding this hearing. I have for some time now been very concerned about the state of capital formation in the United States and want to assure that as we develop the proper policies for our economy, we make it so that America continues to be the place where people come to form capital, and that that can happen not only for large but small businesses alike.

Emerging growth companies seek capital to fund new projects, grow their businesses, and compete globally with their innovative products and services. When unnecessary regulatory barriers to capital formation are removed, everyone wins. Investors enjoy better investment opportunities, consumers enjoy better products at cheaper prices, and local communities enjoy better employment opportunities.

As the December 1st hearing highlighted, we can do more to expand economic activity by removing unnecessary restrictions on capital formation to enhance access to capital for early-stage startups as well as later-stage growth companies. The House recently passed some targeted bipartisan legislation that makes it easier for private companies to raise capital by increasing the 500-shareholder registration threshold, expanding the scope of Regulation A offerings to $50 million, permitting general solicitation of investors in Regulation D offerings, and allowing small businesses and startups to raise capital from small-dollar investors through crowdfunding.

Proposals are also being considered to reverse the American IPO decline while balancing increased capital market access with investor protections. Mr. Chairman, as you indicated, the President's Council on Jobs and Competitiveness' Interim Report and the IPO Task Force provide recommendations that could result in a larger supply of emerging growth companies going public and increase job creation over the long term. The IPO Task Force recommended providing an on-ramp that would provide emerging growth companies up to 5 years to scale up to IPO regulation and disclosure compliance. During this period, emerging growth companies could follow streamlined financial statement requirements and minimize compliance costs and be exempted from certain regulatory requirements imposed by Sarbanes-Oxley and Dodd-Frank.

On December 8th, SBA Administrator Karen Mills and National Economic Council Director Gene Sperling posted a joint online statement about helping job creators get the capital they need by passing legislation relating to crowdfunding, Regulation A mini offerings, and creating an on-ramp for emerging growth companies.

There is strong bipartisan support for these proposals, and I look forward to working together with you, Mr. Chairman, and others to enact the necessary changed to promote investment in the American job growth sector while protecting investors.

Thank you.

Chairman REED. Thank you very much, Senator Crapo.

Senator Merkley, do you have an opening statement?

Senator MERKLEY. Thank you, Mr. Chair. I prefer to get right to the testimony.

Chairman REED. Thank you. Let me introduce the panel.

Our first witness is Professor John Coates. Professor John Coates joined the faculty of Harvard Law School in 1997 after 10 years in private practice in New York specializing in corporate and securities law. He was named the John F. Cogan Professor of Law and Economics in 2008. He teaches and conducts empirical research on corporate and securities law. Thank you, Professor Coates, for being here.

Ms. Kate Mitchell is a cofounder of Scale Venture Partners, a venture capital fund located in Silicon Valley, California. She leads investments in software companies across the United States, bringing more than 25 years' experience in technology development, finance, and general management to her portfolio. Ms. Mitchell was the 2010–11 chairman of the National Venture Capital Association and remains active in policy matters that impact startups and innovation. Thank you, Ms. Mitchell.

Mr. Barry Silbert is the founder and CEO of SecondMarket. Prior to founding SecondMarket in 2004, Mr. Silbert was an investment banker at Houlihan Lokey where he focused on financial restructurings, mergers and acquisitions, and corporate financing transactions. Thank you, sir.

Mr. Stephen Luparello is the vice chairman of the Financial Industry Regulatory Authority, FINRA. In this capacity, Mr. Luparello oversees FINRA's regulatory operations, including enforcement, market regulation, member regulation, and business solutions. Prior to this position, Mr. Luparello served as FINRA's interim chief executive officer.

Mr. Mark Hiraide serves as legal counsel to entrepreneurs in small- and mid-sized public companies, assisting them in private and public securities offerings. He practice includes defending officers and directors in civil litigation arising out of securities offerings and prosecuting civil claims on behalf of aggrieved investors. He also practices before the SEC and FINRA in regulatory defense matters. He entered private practice after having served 8 years as an attorney for the Securities and Exchange Commission in both the Division of Enforcement and Corporate Finance.

All of your written testimonies will be made part of the record, without objection, and so I would urge you to summarize your remarks in a period of about 5 minutes per witness.

Professor Coates, you may begin.

**STATEMENT OF JOHN C. COATES IV, JOHN F. COGAN, JR., PROFESSOR OF LAW AND ECONOMICS, HARVARD LAW SCHOOL**

Mr. COATES. Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for inviting me to testify here today on this topic. Effective and efficient capital regulation is a foundation for economic growth, and it is something that we all have a profound interest in.

I should say at the outset I work as a consultant and as an expert for all kinds of participants in the securities markets, and I do not think any of them have any particular interest in the legislation at issue today, but just so that that is out there, I work for large banks, small banks, individuals, everyone.

In my 5 minutes, I am just going to make a couple of general points and then a couple of specific points about the bills. There is obviously a lot to cover given the different nature of many of the bills on the table.

The first general point is I think all of the bills ought best to be understood not in the way some have cast them as reducing regulation in order to spur growth; rather, they are all efforts to balance the cost of raising capital against the cost of capital. That is to say, there clearly are costs that regulations impose on entrepreneurs who want to raise capital. Simply having to hire a lawyer to know what the rules are is a big part of that. But regulation, at least well-crafted regulation, can reduce the costs that entrepreneurs are charged for the money that strangers give them to run their businesses. In effect, disclosure, antifraud regulation, the ability to verify the information that you are providing and not simply provide the information, all of those things make it safer and easier for strangers to turn their money over and easier for them to reduce the price that they are charging for their capital. So, really, all of the bills are about growth in both directions, and one important, therefore, lesson from that observation is that the bills could harm job growth, too.

The follow-on point to that is that to know for sure how the two kinds of costs tradeoff—capital-raising costs going down, capital costs potentially going up—you would have to know a lot of things that I do not think anyone actually knows, including the SEC, not me, I do not think any of the other witnesses that have testified in the Banking Committee earlier or are likely to testify today.

Here are the kinds of things you need to know: How much more fraud is likely to occur as a result of the changes? There will be some more. I do not think there is anybody who would dispute that. All by itself, that does not mean the changes are bad, but that is something you would need to know.

How much more capital will, in fact, be formed? That is also something I think reasonable people could have disagreements about each of the different proposals on the table.

And so when you start putting together the different kinds of things you would need to know in order to tradeoff the two kinds of costs that are on the table, I do not think anyone can say with confidence how this is going to affect job growth.

Just to restate the point you made at the outset, even market advocates as fierce as Judge Richard Posner have granted that financial deregulation can, in fact, cause job destruction, essentially, as a result of the financial crisis. So how do you think about these bills? They are essentially proposals for experiments, and whenever I think about experiments with something as important as the capital markets, I think they ought to be cautiously adopted.

And, in particular, I would suggest all of them have attached to them a sunset period. If any of them are adopted, you should put them in the law for a limited period of time, direct the SEC to follow what is happening on the ground as they are enacted. Then you will have the information to be able to evaluate the proposals as they are running as an experiment. And then the law should end unless the SEC could be able to satisfy itself that the benefits are outweighing the costs of the changes.

So that would be a general suggestion for all of them. Just a couple quick points on two of them. I do think S. 1933, the IPO bill, is the most carefully written and calibrated, cautious of the bills, the most likely to do more good than harm. I still think it should be sunsetted. The sunset period would need to be several years because the whole point of the bill is to allow a multiyear phase-in to public company status.

I am frankly a little skeptical that some of the changes will do much because I think the downturn in IPOs was not really driven primarily by regulation. The downturn started before Sarbanes-Oxley and continued even after companies had been exempted from Sarbanes-Oxley. Nevertheless, that is not a reason not to try it. I think as an experiment it would be a good idea to try.

On the other hand, I think 1824 raising the 12(g) threshold to 2,000, is the most risky of the proposals, and just to state one simple fact, half of the public companies that are providing to Compustat could go dark as a result of that one change. I do not think the proponents really have thought through whether they want to embark on that kind of radical deregulation without much careful thought.

Just one company, Hyatt Hotels, a public float of $1.6 billion, it has 504 record holders, so it would be able to go dark immediately. I do not think that is the kind of company that the proponents have in mind when they are thinking about raising and making it easier to comply with the 1934 act.

Thank you.

Chairman REED. Thank you, Professor Coates.

We have been joined by Senator Toomey. Senator, do you want to make a few initial comments?

Senator TOOMEY. Thanks, Mr. Chairman. I will pass on that.

Chairman REED. Thank you very much.

At that point let me now recognize Ms. Mitchell. Ms. Mitchell, please.

**STATEMENT OF KATE MITCHELL, MANAGING DIRECTOR, SCALE VENTURE PARTNERS**

Ms. MITCHELL. Thank you, Chairman Reed and Ranking Member Crapo and Senators. Thank you for the opportunity to speak today and for your attention to the issues of capital formation and investor protection. With research showing that 92 percent of a company's job growth occurs after its IPO, restoring access to the public markets for emerging growth companies is of national importance.

In that spirit, I would like to begin by publicly supporting S. 1933, the Reopening American Capital Markets to Emerging Growth Companies Act of 2011. I believe that this bipartisan legislation will help spur U.S. job creation and economic growth at a time when we desperately need both, and it will do so without increasing risk for our country's investors.

My support of S. 1933 is an outgrowth of my service as chairman of the IPO Task Force, a private and independent group of professionals representing experienced CEOs, public investors, venture capitalists, securities lawyers, academicians, and investment bankers. We came together initially at the Treasury Department's Access to Capital Conference in March that Chairman Reed referred to where the dearth of IPOs was discussed at length.

In response to this concern, we formed a task force to develop practical yet meaningful recommendations for restoring effective access to the public markets for emerging growth companies. Because public investors were an integral part of our team, we believe that the scaled regulations that we recommend, which S. 1933 reflects, strikes the right balance between targeted reform and maintaining appropriate regulatory safeguards.

Why do we believe reform is necessary? For the last half-century, America's most promising young companies have pursued IPOs to access the additional capital they need to hire new employees, develop their products, and expand their businesses. However, over the last 15 years, the number of IPOs has plummeted. From 1990 to 1996, over 1,200 U.S. venture-backed companies went public on the U.S. exchanges. Yet from 2004 to 2010, there were just 324 of those offerings.

A number of analyses suggest that there is no single event behind this decline; rather, the cumulative effect of recent regulations along with changing market practices and economic conditions has driven up costs and uncertainty for emerging growth companies and has constrained the amount of information available to investors about such companies, making them more difficult to understand and to invest in.

The Reopening American Capital Markets to Emerging Growth Companies Act of 2011 addresses these issues in two crucial ways.

First, S. 1933 provides emerging growth companies with a limited, temporary, and scaled regulatory compliance pathway, or on-ramp, that will reduce their costs for accessing public capital without compromising investor protection. This on-ramp period will enable emerging growth companies to allocate more of the capital they raise from the IPO process toward growth instead of meeting compliance requirements designed for much larger companies. That means they can use that capital to hire new employees and grow their businesses.

The on-ramp status scales regulations for a small number of elements and would last only for a limited period from 1 to 5 years, depending on the company's size, and would require full compliance as the company matures. In this way, the on-ramp mirrors prior SEC regulatory actions that carefully balance the need for capital formation and investor protection for the very smallest of companies.

Second, S. 1933 addresses the flow of information to investors about these small companies. When our task force surveyed emerging growth CEOs, many of them expressed a concern that the lack of available information about their companies would lead to a lack of liquidity for their shares. Interestingly, institutional investors expressed a similar concern about the dearth of information and exposure they had to IPO companies, making it difficult for investors to make informed investing decisions about these new issues.

S. 1933 improves the flow of information about emerging growth IPOs by allowing investors to have access to research about the companies concurrent with their IPOs. The bill provides a way for investors to obtain research about IPO candidates while leaving unchanged the robust and extensive investor protections that exist to ensure the integrity of analyst research reports.

S. 1933 also permits small companies to test the waters prior to filing a registration statement. By expanding the range of permissible prefiling communications to institutional and qualified investors, the bill would provide a critically important mechanism for emerging growth companies to determine the likelihood of a successful IPO. This also benefits issuers and the public markets by allowing otherwise promising companies to get investor feedback and avoid a premature offering. It is important to note that all of the antifraud provisions of the securities laws would still apply to these communications, and the bill ensures that the delivery of a statutory prospectus is still required prior to the sale of securities.

In all these ways, S. 1933 provides measured, limited relief to a small population of strategically important companies with disproportionately positive effects on job growth and innovation. That is why I urge the Members of this Committee to support the passage of this bill. By doing so, we can reenergize U.S. job creation and economic growth by helping reconnect emerging companies with public capital without compromising investor protection.

Thank you.

Chairman REED. Thank you very much.

Please go ahead, Mr. Silbert.

**STATEMENT OF BARRY E. SILBERT, FOUNDER AND CHIEF EXECUTIVE OFFICER, SECONDMARKET, INC.**

Mr. SILBERT. Good morning, Chairman Reed, Ranking Member Crapo, and Members of the Committee. I am grateful for the opportunity to testify this morning.

The issues raised in my testimony directly impact startup growth, job creation, and American global competitiveness. I am here today representing now just my company and our 135 employees, but also the millions of job-creating entrepreneurs around our country. I founded SecondMarket in 2004 to create a regulated, transparent, centralized market for alternative investments, including stock in private companies. Our unique model allows private companies to create liquidity programs for their stock as well as control every aspect of the program, such as setting eligible buyers and the timing of trading windows.

When a company uses SecondMarket to establish a liquidity program, we require the company to provide financial disclosures to all buyers and sellers in their market. Transparency is a critical factor to ensure investor protection, and we believe that all participants in a company-sponsored program must have access to material information in order to make informed investment decisions.

SecondMarket has become an important part of the capital formation process. By helping companies provide interim liquidity to shareholders, we serve as a bridge to an IPO for companies that eventually want to go public or as an alternative for companies that wish to remain private.

Up until a decade ago, fast-growing startups followed a very similar capital formation path. They raised capital, a few rounds of venture capital, and went public in about 5 years. However, the capital formation process has evolved over the past decade, and the public markets are no longer receptive to smaller companies. It now takes companies twice as long, nearly 10 years, to grow large enough to reach the public market. As a result, private companies are accumulating more shareholders than ever. Thus, I believe that Congress should immediately move to modernize the so-called 500 shareholder rule.

As you may know, the pay structure at startups generally involves giving employees below-market salaries coupled with stock options. These options enable employees to realize the financial upside while also enabling the startup to hire top talents. As a result, this rule has created a disincentive for private companies to hire new employees, raise capital broadly, or acquire other businesses for stock as companies fear taking on too many shareholders and, thus, triggering the public filing requirement.

There has been some recent discussion and even some confusion regarding the mechanics around counting shareholders for public and private companies and the distinction between holders of record and beneficial owners. Today the vast majority of securities of publicly traded companies are held in "street name," meaning that the names of brokers who purchased the shares on behalf of their clients are listed as the holders of record. A broker may own stock on behalf of several thousand beneficial owners, but the broker is considered as only one holder of record.

While this dynamic is applicable to public companies, private companies are quite different as they closely manage their investor base and typically place restrictions on the sale of shares. Accordingly, they do not want brokers holding stock on behalf of individuals unknown to the company. Therefore, shareholders of most private companies directly own the shares and, thus, there is no distinction between the number of holders of record and beneficial owners. Plus, if a private company attempted to use a broker to circumvent the 500 shareholder rule, the SEC could use the anti-evasion in the Securities Act to require companies to count the beneficial owners as holders of record.

I believe that all the bills under consideration today are important for our country's entrepreneurs and will improve access to capital for startups, bolster job creation, modernize and improve investment protection, and help entrepreneurs pursue the American dream. However, I wish to focus on three that warrant immediate passage.

First is S. 1824, which increases the shareholder threshold from 500 to 2,000 record holders and also excludes employee owners from the counts. The bill also contains a provision to allow publicly traded community banks to deregister from the SEC if they have less than 1,200 record holders. Worth noting, this provision does not apply to other publicly traded companies and will not increase the instances of companies going—nonbanks going dark. So this means that Hyatt could not go dark under this bill, and I would encourage Professor Coates to reread the draft legislation.

There is strong support for this bill across the private sector and a multitude of industries. This week, a letter was sent to Congress signed by some of the leading American technology entrepreneurs, venture capitalists, and angel investors urging immediate passage of the bill. And just yesterday, the Progressive Policy Institute, an independent think tank, issued a white paper strongly endorsing the legislation.

The next bill is S. 1831, which eliminates the ban against general solicitation in the context of private placements provided that the purchaser qualifies as an accredited investor.

And, finally, I fully support S. 1933, which establishes an on-ramp for a new category of small issuers to help them go public.

These complementary bills will make it easier for smaller private companies to flourish and grow into large job-creating public companies. The problems facing startups must be addressed, and the failure to support these young companies will significantly limit access to capital, restrict job growth, stifle innovation, and weaken the U.S. globally.

Thank you.

Chairman REED. Thank you very much.

Mr. Luparello, please.

**STATEMENT OF STEPHEN LUPARELLO, VICE CHAIRMAN, FINANCIAL INDUSTRY REGULATORY AUTHORITY**

Mr. LUPARELLO. Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, thank you for the opportunity to testify today. My name is Steve Luparello, and I am vice chairman of the Financial Industry Regulatory Authority, or FINRA. We ap-

preciate the Subcommittee's continued focus on improving access to capital for startups and small businesses while maintaining protections for investors.

The Federal securities laws provide protection to retail investors through several mechanisms: antifraud authority, disclosure, regulation of intermediaries, qualification of investors, and market regulation. These fundamental protections are intended to achieve two primary objectives. First, they are designed to protect customers from abusive or fraudulent practices. Second, and equally important, they are intended to provide the investing public with confidence that market participants will treat their customers fairly.

In the course of our work, FINRA examines broker-dealer firms for compliance with the securities laws, SEC rules, and our own rules. That work covers the panoply of business models, products, and communications used by broker-dealers. Per this Subcommittee's request, I will focus my comments on the types of activities and scenarios FINRA sees in the area of unregistered securities and microcap fraud and the role that oversight of intermediaries plays in the fabric of investor protection.

Given that the current private placement market is a relevant analogy to a number of the capital-raising proposals under consideration, we believe our experience with that market may be helpful to the Subcommittee.

The private placement market is an essential source of capital for American business, particularly small firms. Regulation D under the Securities Act of 1933 provides the most important avenue for a company to privately issue shares. According to one estimate, in 2008 companies intended to issue approximately $609 billion of securities in Regulation D offerings.

Private placements are an important source of capital for many U.S. companies and are often sold directly by issuers without the service of intermediaries. That said, intermediaries often play a role, especially when the issuer seeks to reach a broader set of potential investors. In those situations, investors rightly have an expectation that the intermediary will be objective.

Throughout our examinations and investigations, FINRA has found significant problems in this segment of the market, including fraud and sales practice abuses in Regulation D offerings. FINRA recently sanctioned a number of firms and individuals for providing private placement memoranda and sales material to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions.

As a response to these problems, last year FINRA issued guidance to firms reminding them of FINRA's suitability rule and broker-dealer obligations to conduct a reasonable investigation prior to recommending Regulation D offerings. The guidance also made clear that the requirement to conduct a reasonable investigation is a duty of the broker-dealer that arises from a long history of case law and under FINRA's just and equitable principles of trade. This duty requires the broker-dealer to understand the Regulation D securities and take reasonable steps to ensure that the customer understands their risks and their essential features.

In October, FINRA filed with the SEC proposed rule amendments specifically to require that firms make basic disclosures

about private placements that they recommend to their retail customers. Still pending at the Commission, this proposal would require firms to disclose the anticipated use of offering proceeds, the amount and type of offering expenses, and the amount and type of compensation to be paid. The proposal would also require notice filings with FINRA of a broker-dealer's private placement activities.

Turning to microcaps, this market consists of issuers that are often startup or shell companies whose stock is thinly traded in the over-the-counter market. These companies generally are not followed by independent financial analysts, and the publicly available information about the company may not provide a sufficient basis to evaluate the company's claims about its business prospects.

FINRA has referred over 500 matters to the SEC in the last 2 years involving potential microcap fraud. Often fraudulent schemes in microcap stocks seek to exploit well-publicized news events or trends. We have referred matters to the SEC involving stocks linked to China, the gulf oil spill, gold, and clean energy.

As noted above, Federal securities laws and SRO rules provide a variety of protections to retail investors. The legislative proposals currently under consideration attempt to build in some or all of those mechanisms. We hope that by sharing our experiences in dealing with the regulatory challenges in the private placement market, we will provide useful insight as the Subcommittee continues to evaluate the many bills pending relative to this issue.

We would be happy to continue to work with the Subcommittee and its Members as you consider how best to balance the goals of providing new opportunities for building capital while protecting investors.

Again, thank you for the opportunity to share our views, and I would be happy to answer any questions that you have.

Chairman REED. Thank you very much.

Mr. Hiraide, please.

**STATEMENT OF MARK T. HIRAIDE, PARTNER, PETILLON, HIRAIDE & LOOMIS, LLP**

Mr. HIRAIDE. Chairman Reed, Ranking Member Crapo, distinguished Members of the Committee, thank you very much for the opportunity to appear here today to discuss risks in investor capital raising. My name is Mark Hiraide. I am a partner with Petillon, Hiraide & Loomis in Los Angeles. I am a securities lawyer and, of course, I am familiar with the costs associated with raising capital that Professor Coates referenced.

The importance of early-stage capital to our economy and the challenges to entrepreneurs in accessing it, even prior to the recent economic downturn, has been well documented. In my experience, a startup's first seed capital of investment, the investment between $250,000 to about $500,000, is critical to the development of a healthy equity market food chain. By that I mean this initial funding level allows technologies and concepts to be validated or not. With such validation, our client entrepreneurs may then move up the food chain to be considered by professional venture capital and angel investors. I believe that the failure to feed this portion of the food chain is in large part responsible for the starvation of the IPO market.

Now, can the Internet and modern communication technologies help close the funding gap? If the current statutory limitations on conducting private offerings are eliminated, what are the risks to investors? I look forward to answering your questions regarding each of the bills being considered by the Committee. However, I would like to share my experience that may prove helpful in your consideration of the crowdfunding legislation, as this legislation has the greatest potential for abuse, along with the risk of going dark, which Professor Coates referenced.

Yes, it is true that one of the bills, S. 1824, relates to increasing the 500 shareholder limit under Section 12(g) relating to banks, but other legislation being considered would apply that across the board to all companies.

Attempts at utilizing technology to make processes more efficient, in this case the market for seed and early-stage capital, are not new. In the early 1990s, as the world was for the first time coming online, "disintermediation" was the mantra. Technology would cut out the middleman. In the case of the market for early-stage capital, however, it did not.

In 1997, the Small Business Administration's Office of Advocacy, working with the SEC and NASA, launched the Angel Capital Electronic Network, more commonly known as ACE–Net. It was an Internet-based matching service for accredited investors and entrepreneurs seeking up to $1 million in seed financing. Although ACE–Net provided a mechanism through which entrepreneurs could conduct a general solicitation of their offering, ACE–Net was not successful, in part because sophisticated investors simply did not identify investment candidates by searching companies at random over the ACE–Net portal. Without an active connection between entrepreneurs and the investment community, deals did not get done. Although today many more people are connected through social media, a passive portal or even several of them through which an investor may access potentially hundreds of investment opportunities may not be the catalyst to spur seed round capital formation.

The old adage that securities are sold, rarely are they purchased, especially by nonprofessional investors, was as true in 1997 as it was in 1933 and as it is likely true today. We learned that more sophisticated individual investors invest when the investment has, in some sense, been validated. Although this validation may come in the form of participation in the offering by recognized investors, most often, it is based on a recommendation from a trusted advisor.

Yes, the sharing of information by crowds will force entrepreneurs to answer important questions. However, we cannot ignore that the active involvement of securities professionals, both those regulated by Mr. Luparello as well as those unregulated, participate in the capital raising process and this is a reality that is critical to capital formation.

Now, if I can just address for a moment the unregulated market, in Southern California as well as other places around the country, the so-called securities consultants have emerged. Others refer to them as boiler rooms. They are a class of unregulated securities salespersons who work to develop relationships with individuals, many of whom were at home and retired. Although oftentimes the

individuals solicited appeared on a list of purportedly prequalified investors, in most cases, investors were solicited by telephonic cold calls. Eventually, the experienced unlicensed salesperson indeed developed a preexisting relationship with the investors as many of these investors serially invested in deals offered by the salesperson. For the unlicensed securities intermediary, this investor pool served as their wellspring, which they continued to tap, generating for themselves literally hundreds of millions of dollars in commissions during the Internet boom and beyond.

I believe the challenge in adopting new legislation to stimulate early-stage capital formation is to maintain effective regulation over those professionals while not imposing too high a regulatory barrier to entry and to ensure incentives are not inadvertently created that lead to the formation of unregulated securities markets.

I look forward to answering your questions.

Chairman REED. Thank you very much. Thank you all for your excellent testimony.

We will do 7-minute rounds, and if we want to do a second round, I think we will have the time. We have a vote at 10:45, I am told.

Thank you all again. One of the conclusions that I think emerges from all of your testimony, both written and oral, is that this is a multidimensional problem as a result of actions taken over probably two decades, some intended, some unintended. And I was particularly struck with Mr. Silbert's testimony, where he laid out the problems in the public stock market: Online brokers, which takes the place of the trusted advisor who you knew and was registered; decimalization; Sarbanes-Oxley; global research settlement, which restricts access to research for these new companies; high frequency trading, which is now 75 percent of the trading, and startling to me, over the past 40 years, the average time the public market investor holds stock has dropped from approximately 5 years in 1970 to less than 3 months today, which essentially suggests that the market is not a place where someone is going to invest in an emerging company, hold it, *et cetera*. This is just get in and get out as fast as you can. And it also raises the question, too, given the shock of 2007, 2008, *et cetera,* of just the public's appetite to invest in the stock market at this time.

So with all of these factors together, and it goes back to a point I think Professor Coates suggested, all this legislation is thoughtful and meaningful, but is it going to fix the problem? Is the problem much bigger than that? Is it about investor confidence? Is it about all the factors Mr. Silbert laid out so graphically? And will this have any effect, any of this legislation, or are there much bigger problems? And that is sort of a cosmic question, so I will begin with Professor Coates and ask all the panelists to respond.

Mr. COATES. So I think the answer is consistent with what I said in my opening remarks, which is I do not know whether all of this will do anything. I think, as I indicated, S. 1933, as crafted, is the most promising as a way to reduce some of the marginal costs faced as a company approaches an IPO. If you think about what a company approaching an IPO is wrestling with, they are having to adapt their mindset to projecting to a public that they have never had to deal with before, and if you add to that having to also

completely redo the relationship with their auditor because they are going to be subject to Sarbanes-Oxley, I could see that that might deter some companies from making that final step. And since the effect of the bill would be to delay and not eliminate the need to develop a good control system, one that a good, big public company ought to have, then I think it is an experiment worth running, but I do think it is an experiment and it is something that ought to be watched carefully.

I think if you took all of the bills as currently written and passed them all, I honestly think collectively they would have the opposite effect of what they are all individually intended to do because I do think each of them opens the way to different types of potential fraud, different types of potential abuse by some people, not all, but some. And all it would take is for a significant front-page story about a crowdfunded fraud to reap fairly severe damage on the existing successful business models of companies like Mr. Silbert.

So that is why I urge caution and I urge that each bill be thought about separately and together to think about the possible effects, but to sunset whatever you do and have the SEC track closely what is going on on the ground.

Chairman REED. Ms. Mitchell, your comments, please.

Ms. MITCHELL. I will be quick, and I agree with Professor Coates that S. 1933, the nice aspect of that piece of it is that it builds on existing regulation, because straying too far away from that, we thought, was not appropriate from an investor protection point of view.

The question you asked about is there a bigger issue here, I think is a very fair one. Certainly, IPOs are impacted by broader economic cycles, such as what is happening in Europe and what is happening in credit markets, so there is absolutely no doubt about that.

It is interesting, though. When you looked at the CEO survey that we did, and it came out much more strongly than I would have expected, over 85 percent of pre- and post-IPO CEOs were concerned and felt that the markets were not as friendly as they were back in the mid-1990s, the time that we really want to bring back, and that reticence, therefore, to want to build a company that could go public and take it all that way is what is really hurting the economy.

And again, we do not want to go back to the bubble period of 2000. I think there were a lot of things about that that were wrong, and why this regulatory structure makes sense that we have got today and why we want to work within it. But when you go back to 1990 to 1995, there were 496 IPOs per year under $200 million, and those were small companies. This year, it is 89. Last year, it was 120. We have not gotten over 200 in the last decade. So it really is down.

Interesting, and it was noted in the IPO Task Force Report, the returns for the first year post-IPO exceeds that of the broader market. And when we talk to institutional investors across the board, their frustration on behalf of their retail constituents, meaning pensioneers and the retail investors and their funds, was they could not get access to the growth that they were able to in the late 1980s and 1990s. They like regulated markets because they are

more consistent, fair, transparent, and they cannot get the growth for their clients, and again, pensioneers and retail customers, that they could previously. So——

Chairman REED. Thank you.

Ms. MITCHELL. ——I think both are true.

Chairman REED. Mr. Silbert, then we are going to get everybody.

Mr. SILBERT. So thank you for making note of my testimony. I think we have got three choices. We can do nothing. We can try to fix all the public market's problems. Or we can make incremental fixes and changes when it makes sense.

You know, Kate did mention in her testimony that there was not one cause of all of this. I think at the end of the day, if you look at this as efforts to create jobs, these create jobs. You know, with all respect to Professor Coates, in reading his bio, I am not sure he has personally created jobs. In talking with technology entrepreneurs, in talking with angel investors, in talking with venture capitalists, they are all behind this. The New York Stock Exchange is behind this. Wawa is behind this. Cargill is behind this.

So at the end of the day, while I would love to have a separate conversation with you about the broader public market issues, I think specifically as it relates to this legislation for trying to create jobs, this is all good for job creation.

Chairman REED. Mr. Luparello.

Mr. LUPARELLO. Mr. Chairman, I would quickly align myself with your statement about the need to look at the broader issues especially around market structure and the secondary market. Whether it is around incentives to provide liquidity or disincentives to provide liquidity or just fundamental investor confidence based on things like high-frequency trading, fixing the front end of the market without analyzing the market structure issues that also continue to be out there, that seem to be creating barriers to individual investors wanting to participate, is essential to get the broader look at the picture.

Chairman REED. Thank you.

Mr. Hiraide.

Mr. HIRAIDE. Yes, Senator. After having practiced securities laws for 27 years, I agree with Professor Coates' characterization of the bills as largely an experiment, underscoring the need to carefully consider the consequences, both intended and unintended.

I also agree with Professor Coates regarding the cost of accessing capital and balancing it against the cost of capital. Increasing fraud, increasing loss of investor integrity of the market is going to raise costs of capital and impact job growth.

One comment with respect to this issue of going dark. The going dark issue has to do with eliminating the requirement to comply with the Securities Exchange Act of 1934, protections such as periodic reporting, insider trading restrictions, other restrictions such as those. The issue of going dark is very concerning to me because many companies with many large numbers of shareholders will be able to go dark. By increasing the limits both to enter the system but also to exit the system, it is going to, in my opinion, largely increase the number of companies that will not be subject to 1934 Act reporting, 1934 Act protections, as well as the other protections that publicly traded companies are afforded. Thank you.

Chairman REED. Thank you.

Senator Crapo, please.

Senator CRAPO. Thank you very much, Mr. Chairman.

I think I would like to explore with the panel this issue of going dark a little better so we understand it, because—and I will start with you, Professor Coates, and we can let others who want to get in on this discuss it. Professor, you indicated that raising the shareholder threshold cap to 2,000 would allow more than half of the public companies to go dark.

As I understand it, though, S. 824 would allow a private company going forward to take advantage of the new provisions, but that if a nonbank currently public company wanted to try to deregister, they would still be subject, as I understand it, to the deregistration requirements of the code. Then they would have to meet the current 12(g)(4) requirements that nonbanks must have less than 300 record holders before they could deregister. Am I missing something there?

Mr. COATES. No. I think that is absolutely right. The point that I was trying to get across was that companies like Hyatt, and just to pick another one, Accenture, currently has less than 100. So it would not have to comply with the 1934 Act unless it chose to, which it has obviously chosen to do.

But your question is a great question because it points out that, currently, the 500 shareholder rule is itself outmoded. That part I agree with the proponents of the revisions. But the reason it is outmoded is because nobody uses recordholders in the way that people used to. Almost all new public companies have brokers intermediating between the ultimate shareholders and the company. And so it would not require an intentional fraudulent scheme, as Barry was suggesting earlier, to produce the ability of companies to remain completely private. It would just be most normal public companies will increasingly be able to remain outside the scope of the 1934 Act if they choose to by having the intermediaries between them.

Senator CRAPO. So that is prospective, right?

Mr. COATES. Absolutely, and I assume that is the kind of companies that Barry is mostly focusing on. I was using Hyatt as an example of a very large company as an illustration of the kind of company we would not think we would want to be private, with as many shareholders as it, in fact, has.

Senator CRAPO. So then I will let others who want to speak on this do so, but if I understand you right, then you are not saying that the bill would allow half those currently registered companies to go dark. What you are saying is that companies like those that——

Mr. COATES. Yes.

Senator CRAPO. —are currently registered would not have to comply if the law were changed.

Mr. COATES. Correct, but I would add one other thing, which is that unless the recordholder test is changed to something more sensible, like beneficial holders or public float, over time, the companies will, in fact, be able to go dark because they will be below 300, which is the test that, as you suggest, would prevent them

from exiting the system. So there is a problem. It is just not the one that is being identified in the bill.

Senator CRAPO. Mr. Silbert, did you want to respond?

Mr. SILBERT. Yes. Thank you. So let us separate this into two issues. There is the way the bill reads. Just so I think everybody is clear, the bill does not allow nonbanks to go private, to go dark. There is no change to that. It is still 300. The change is with respect to community banks.

So on the topic of record versus beneficial owners, as I had mentioned in my written and oral testimony, Hyatt or any of these folks, they could do it today if they wanted to, if they wanted to try to cram their thousands of shareholders into 300 slots. So this draft legislation does not affect their ability to do that.

But as I mentioned before, as well, private companies, recordholders equals beneficial. It is really that straightforward. We are unaware—I am unaware of any instances where that is not the case. It is different in the public market. In the public market, there are a lot of benefits to doing it in street name, but there is not in the private market.

Senator CRAPO. Thank you.

Mr. Hiraide, did you want to——

Mr. HIRAIDE. Yes. Thank you, Senator Crapo. I was referring to other legislative efforts that I wrote about to reduce the 12(g) limit with respect to nonbank companies. But as I understand S. 1894, applicable to bank and bank holding companies, it will reduce the—increase the 12(g) deregistration from 300 to 1,200 shareholders. And again, that is shareholders of record, not beneficial owners. So all those shares held in street name are not counted.

The concern I have with going dark, whether it is applied to bank or nonbank, is that the company is not subject to, again, the stringent requirements of the 1934 Act. As an example, a company would be able to go dark, then no longer report to its public shareholders other than the information that is required by State law, which is very minimal. The company could then effect a going private transaction. That is, they could cash out minority shareholders and not be subject to the 1934 Act's requirement under Rule 13(a)(4), which requires very comprehensive disclosure when a company goes private, that is, when it cashes out minority shareholders.

The 1934 Act requirements require full disclosure, sunshine, about all of the conflicts of interest in a cash out transaction. Typically, you have the majority controlling shareholder cashing out the minority. The minority is not able to negotiate, and so the minority is forced to accept the price that the majority shareholders determine is fair.

Now, the State law, of course, imposes fiduciary responsibilities on the directors of the corporation, but the kind of sunshine provisions, as I call them, the disclosure provisions under the 1934 Act, the protections that Rule 1383 affords, provides kind of a prophylactic that the transactions will be fair to minority shareholders.

Senator CRAPO. All right. Thank you.

Ms. Mitchell or Mr. Luparello, did you want to respond on this one? All right.

Then my last question, then, I would like to direct to you, Ms. Mitchell. I am looking at the "Rebuilding the IPO On-Ramp" report and I am looking at the chart that shows the information you presented about the decline of U.S. IPOs. For some time, we have actually had on our side a Republican task force on capital markets, trying to figure out why we are seeing this precipitous decline in the United States and what we can do about it, and I would just like to ask you if you could, in terms of your role as a leader in this report, just explain what are the various factors that you think have led to the decline of our IPOs in the United States from the mid-1990s to today.

Ms. MITCHELL. Well, certainly, and it is interesting, when you look, by the way, at the data that is in that report, what you see is actually the decline in IPOs begins when a lot of these regulations start to be implemented, which actually even predate Sarbanes-Oxley, which is 2002 and the late 1990s, electronic trading, decimalization, *et cetera.* And you see the IPOs start to decline, particularly small company IPOs as the economy continued to not only grow, but, in fact, boom. So you see that while economic cycles certainly make a big impact on small companies, these regulations have also had a significant impact.

And when we spoke to CEOs, their perspective on this is that it is very daunting. They are concerned that they are unprepared, that it takes too much of their capital. If I am a small company, every $100,000 I have in front of me—I have duct tape on my carpet—every $100,000 in front of me is a choice. Do I hire a new employee or do I prepare to go public in a market that is uncertain? It has become so much more expensive, and they often choose to build their company. But that is why we have almost 90 percent of the companies today being sold off to larger companies as divisions, which, in fact, serves to reduce jobs, not bring them forward.

So that is why we went back and said, what can we do to make a meaningful impact on that but yet be practical in our approach? Let us see what we can do to reduce the cost and improve investor communication, but do so in a way that does not disrupt markets, as Professor Coates referred to.

Senator CRAPO. Thank you.

Chairman REED. Thank you very much.

Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you all for your testimony.

I wanted to shift to the crowdfunding issues and specifically how we balance the ability to raise substantial sums for small companies against the accountability and avoid the boiler room challenge that was mentioned or "pump and dump" schemes, *et cetera.* I have introduced a bill in partnership with Senator Bennet and Senator Landrieu to try to strike a balance, after consultation with a number of experts, and that is S. 1970.

But I wanted to specifically start, Mr. Hiraide, with I think you have had a chance to look at that. We put in individual limits, per person, per company. We set, if folks are more affluent, $50,000 annual income, they can invest larger amounts, 1 percent of their income. More than $100,000, they could invest more. We have left to the SEC the ability to regulate the number of individual stock in-

vestors. You can raise $1 million a year. We have left in accountability for the accuracy of the statements that are issued, basic financial information that would have to be provided. Those are the basic outlines of what we have tried to do to give enough information.

And then, also, we have put in a rapid response fraud clause in which every 6 months for the first 2 years, the SEC would do a report, a study of fraud on the crowdfunding activities, and would have the power to adopt rules to address issues that come up so that we try to be able to respond quickly to making sure that blatant issues are addressed with the viewpoint that confidence, investor confidence, is extremely important to maintain if this is going to be a successful avenue for people to raise funds and successful for investors to make money, if you will. Those are the basic outlines, but I just wanted to get your thoughts.

Mr. HIRAIDE. Yes, Senator. I am familiar with all of the crowdfunding bills, the bill that was passed by the House as well as the two in the Senate, including S. 1970.

Let me say that I fully support the intent behind the crowdfunding bills. However, I share Professor Coffee's concerns that unregistered salespersons may abuse the broker-dealer exemption set forth in Section 7 of the S. 1791 Senate bill. Unregistered salespersons of the sort that I describe, I think, will, with little effort, satisfy the requirements for the exemption from broker-dealer registration in Section 7 of S. 1791.

On the other hand, S. 1970 that you mentioned adopts a regulatory regime for intermediaries that require them to either elect to register with the Commission as a broker-dealer or as a newly defined funding portal, be subject to several definitional prescriptions. S. 1970 appropriately limits the scope of permissible activity of a funding portal by prohibiting it from offering investment advice, soliciting purchases, compensating employees, agents, or other third parties for such solicitation.

S. 1970 also provides reasonable limits on maximum individual investment limits. I think by including an aggregate limit applicable to all crowdfunded investments in addition to dollar investment limits per company, S. 1970 addresses a concern known as stacking, whereby an individual investor invests in successive offerings but manages to satisfy the requirements of each individual offering.

I think, finally, again, with respect to S. 1970, the million dollar exemption limit may be adjusted by the Commission to reflect the annual change in the Consumer Price Index, and I think if the Commission were permitted by rule to increase the exemption limit, the exemption, if successful for seed offerings up to a million, could be scaled up to cover even a greater portion of the funding gap.

So I do believe that S. 1970, while again keeping in mind that all of these bills are experimental efforts, including this one, I think S. 1970 does balance the need to facilitate access to critical seed capital with important investor safeguards.

Senator MERKLEY. And you referred to the million dollars as a million dollars per year, but I take your point about being scalable.

Mr. Silbert, you are immersed in thinking about these kinds of issues. Do you have a sense of how some of these different strategies might be striking the right balance or might be missing the mark in terms of a reliable crowdfunding marketplace?

Mr. SILBERT. So the concept of crowdfunding is an exciting one. It is one that I think we have seen some initial success with on projects. You know, Kickstarter is an example that is used frequently. I am not aware of there being any fraud issues there. I also understand that overseas, there are some successful crowdfunding platforms. You know, specific kind of safeguards, which I agree are incredibly important. I think investor protection is very important.

I cannot comment specifically on what has been suggested, but I do think that is, whether it is considered a pilot or what have you, it is a very exciting opportunity for us to create additional capital flows to these small growing businesses.

Senator MERKLEY. Well, I will look forward to following up with you to bring some more specifics and what we have learned from the foreign examples which we have been examining.

Would anyone else like to kick in on this crowdfunding approach? Yes.

Mr. LUPARELLO. I guess I would add that to the extent to which the bill focuses clearly on the role of intermediaries and the increased likelihood of fraud, it is focusing on exactly the right things. We have concerns in the private placement market that we regulate now that intermediaries can play a very helpful role, but can also, again, because of that expectation of objectivity, play a very destructive role. And looking at the obligations that get placed on intermediaries in the crowdfunding space is as important as it is in the private placement space that exists right now because there will be possibilities for fraud, and that ability to enforce both against issuers and intermediaries will be important to ensuring that there is no loss of confidence in this effort.

Senator MERKLEY. One thing we tried to do was leave in—and I will just close with this closing comment because my time is up—but to require the entrepreneur who is providing the information to be accountable for material misstatements or omissions so that there is a real direct incentive to be presenting accurate information. That is one of the many pieces.

Thank you, Mr. Chair.

Chairman REED. Thank you very much.

Senator Toomey, please.

Senator TOOMEY. Thanks very much, Mr. Chairman, and thanks to all the witnesses for this very helpful testimony.

I would like to ask a question of Ms. Mitchell about bill 1933, but first I just want to comment on the characterization that Professor Coates and I think Mr. Hiraide have made about these bills as a series of proposals for experiments.

At least in the case of 1933, certainly, it seems to me that one of the central provisions, one of the most important provisions in this bill, if not the most important provision, is the fact that it would allow these emerging growth companies for a limited period of time—so a very small subset of all companies for a limited period of time—to simply be relieved of a relatively new regulation,

which is 404(b) of Sarbanes-Oxley, which is only about 10 years old. So for untold previous decades, while the United States capital markets became the largest, deepest, most efficient, most sophisticated, most advanced markets in the history of the world, we never had any such regulation during that entire period of time. So to suggest that we simply go back to that regime for a brief period for a small subset of companies does not strike me as terribly experimental, but it does strike me as very constructive for the companies that would otherwise be faced with the very, very expensive cost of complying with this provision.

But I had a narrower question for Ms. Mitchell, if I could, which is, with respect to this bill, is it your understanding that this bill would actually reduce or eliminate the ability of the SEC and FINRA to regulate analysts with respect to small companies? Or would it, rather, enable the small emerging growth companies to simply get the kind of coverage that bigger companies get?

Ms. MITCHELL. Absolutely. Senate bill 1933 that you sponsored absolutely builds on and extends existing regulations. We really made a point of wanting to be, again, meaningful but practical. And when it comes to investor communications, yes, it modernizes it; yes, it allows small companies to have the same ability to communicate with investors as large companies do. It does it within the context of existing regulations, and SEC and FINRA absolutely continue to regulate this market, particularly for research analysts.

I would also say, by the way, to your comment earlier about 404(b), I agree. I do not see that as an experiment—you know, certainly an experiment to recent history, but not our long history; and, second, not an experiment if I am Ford Motor Company and going public, I get 2 years to comply with 404(b). We are simply saying for a smaller company, give me another 3 years.

So, again, we were looking to do things that really built on existing regulations to go forward, including investor communication.

Senator TOOMEY. Thanks. I look at it as giving small companies the opportunity to grow into the ability to handle this cost.

Ms. MITCHELL. Absolutely.

Senator TOOMEY. Thanks very much for that. I have a couple questions for Mr. Silbert, if I could, about bill 1824, because it seems to me—and I was hoping you could develop it from the testimony that you provided—that in many ways the limit that we have on shareholders now has unintended consequences that curb the ability of small companies to grow and prosper and have the unintended effect of making our capital markets less efficient.

So, for instance, you point out that this limit on the number of shareholders under current law makes it harder to compensate employees, especially prospective employees, with stock options, because over time options get exercised, you have new shareholders. Is that a significant consideration, do you think, for growing companies?

Mr. SILBERT. Absolutely. The fact that this bill has been characterized as an experiment I do not think is necessarily the right way to look at it. It really is updating a rule that was put in place in 1964, so we are almost 50 years later now. The markets have changed. Companies are staying private twice as long as ever.

Senator TOOMEY. I acknowledge that. I just want to make a couple of other points. Just to observe the other ways in which we are limiting flexibility and growth in these companies, tell me if you disagree. One is the ability of small and growing companies to acquire other companies using their stock as a currency, which I know from personal experience can be a very, very important way to grow. Do you——

Mr. SILBERT. I agree. The ability to buy other companies with your stock has not been an option for private companies.

Senator TOOMEY. So we curtail the flexibility of these companies to expand in their marketplace or others. I do not remember seeing this in your testimony, but it strikes me that given the shareholder limitation, if a company needs to grow and needs access to capital, could this have the unintended—the current low shareholder threshold, could it have the unintended effect of driving companies a little bit on the margin, more toward debt instead of equity? You can go to a bank and borrow more money without triggering these requirements.

Mr. SILBERT. I think that probably happens, and I think it is important to understand that enabling companies to raise capital with the institutions and accredited investors on a broader basis is going to result in lower cost of capital for those companies.

Senator TOOMEY. And, Ms. Mitchell, at the end of the day this increase in the number of shareholders would, as a practical matter, allow more—typically accredited investors, and that is who is typically making these investments.

Ms. MITCHELL. Right, right.

Senator TOOMEY. So these tend to be sophisticated people——

Ms. MITCHELL. Absolutely.

Senator TOOMEY. ——who have the knowledge, the experience, and the ability, and the resources to understand what they are getting themselves——

Ms. MITCHELL. Some of the same investors that end up investing in IPOs are the same investors that this bill refers to as well, and it provides flexibility for these companies so that they can time their approach to the market when they are ready and when the markets are friendly to IPOs.

Senator TOOMEY. And I welcome any input from anybody on the panel, but it seems to me the cumulative value of giving greater flexibility in terms of whom you hire and ways that you can compensate potential employees, greater flexibility in how one acquires other companies, diminishing unintended consequences such as perhaps favoring debt over equity, and the fact that the expanded universe would apply mostly to accredited shareholders anyway, I think the cumulative effect of these is clearly progrowth and clearly encourages the growth of these companies. But I would welcome comments from anybody on this.

Mr. COATES. I have already said I disagree with your last general statement, but I will make just one point about the expansion of the record holder trigger. It has been referred to frequently as outdated. I have not seen anybody articulate why. Unlike the asset threshold which has to be adjusted with inflation over time to reflect growth in the economy, the 500-shareholder threshold originally was meant to be a test for the capacity of dispersed share-

holders who do not know each other, who do not have an ability to communicate with each other very easily, and even if they can, have a hard time coordinating their action, to use their rights collectively that they have to own the company, their rights as owners of the company. And it seems to me that 500 still remains a pretty good number for thinking about how difficult it is to organize and get people to agree. I think that is roughly the number of people in Congress, and Congress sometimes has a hard time getting coordination among itself. And 500, it seems to me like a reasonable number to use even today for difficulties of dispersed owners to coordinate their activities.

Senator TOOMEY. I would just suggest that Congress is dysfunctional for many reasons that might not relate directly to the numbers, but I would also suggest the ability to communicate is now just unspeakably superior to what it was when this regulation was put into effect, and to share information.

Mr. COATES. With due respect, not about coordinating, for example, a proxy fight, a lawsuit, something to enforce one's rights that you have as an investor in a company, those things actually remain quite difficult to accomplish. Even for publicly held companies with 30 institutions, they have a very hard time sometimes getting together to put pressure on a board to do something that is clearly the right thing to do.

Mr. TOOMEY. I see I am running out of time, but if the other panelists would have a chance to respond, Mr. Chairman, I would appreciate that. Any further comments?

Mr. HIRAIDE. Yes, Senator. I agree with you completely that having stock as currency is very critical to our economy. I would note, though, that unless there is a public market for the stock, most investors are not going to be likely to want to take stock as currency unless they have the opportunity to liquidate.

One other comment about Section 404(b) of Sarbanes-Oxley, and I can only share with you my anecdotal experience, but we have had—404(b), of course, is the requirement that an outside auditor attests to the internal controls of management. We have had the requirement on the books since 1977 with the enactment of the Foreign Corrupt Practices Act to maintain adequate internal books and controls. When Sarbanes-Oxley was enacted, frankly I wondered whether or not we needed to have an additional requirement to have outside auditors look at the internal controls when the requirements were already on the books.

Similarly, with SOX's requirement to make the CEO and CFO certify a number of matters that they were already liable for under the existing provisions of the 1934 act because they were required to sign documents filed with the SEC prior to the enactment of SOX.

But now, after having experienced SOX and counseled companies in a number of years since the enactment of SOX, I have to say that those requirements of SOX, in my opinion, significantly enhanced the accuracy of the financial reporting. For some reason, the CFO and the CEO having to sign a certification makes a difference. Similarly with SOX's corporate governance provisions regarding committee charters, for some reason having the charter, having the requirement that the committee actually have a charter

that the directors have to sign and read enhances corporate governance.

Now, with respect to Section 404(b) in particular, I think initially when SOX was first adopted, there was quite a bit of uncertainty and costs associated with complying with 404(b), I think primarily because it was a completely new requirement. SOX created a completely new agency, the PCAOB. The PCAOB was enacting completely new regulations, and so there was a lot of uncertainty after SOX's initial implementation about how to comply. And, yes, it did increase very significantly the costs for public companies of complying. But I think those were initial transitional costs. For the most part, our clients now understand what the requirements are. Again, those requirements have always been on the books. The requirement of 404(b) is simply that the auditors come in and attest to management's assertions about the adequacy of internal control. And I have to say that after the experiences with Enron, Adelphia, and Tyco, which all occurred before SOX—and, again, while the requirement to have adequate internal controls was on the books, the inclusion of the 404(b) requirement, in my opinion, enhances the accuracy of financial reporting.

Senator TOOMEY. Thank you, Mr. Chairman.

Chairman REED. Thank you, Senator Toomey.

The questions of all my colleagues have been extremely thoughtful, and to raise just two general areas that I would like to quickly raise, one, Ms. Mitchell, it seems—and I might be grossly mischaracterizing it—that the choice for the emerging entrepreneurial private company is do I go public or do I sell to a big company. And we are trying in these various legislative proposals to reduce the costs of going public. But I will ask you since you are a practitioner. It would seem to me that if someone comes in and says, "I am buying the company, here is a check," that is a pretty costless—you know, relatively costless transaction on the part of the entrepreneur. Is there any way—I am being a little melodramatic—any way you can lower the cost enough with these proposals that that option is no longer attractive? Or I guess alternatively, have we found ourselves in a situation now where there is not really, given this competing alternative with big companies that are going out aggressively buying other companies, that that is the reason why the IPO market is not so hot any longer and that is not going to be directly affected by what we do or may do?

Ms. MITCHELL. Well, certainly an M&A transaction can be attractive in the short run, and particularly even to the private investors that are invested in a small company. The cost of that, though, is future growth and job creation. You know, one of my colleagues often says, "Imagine what Seattle would look like without Microsoft and what Silicon Valley would look like without Intel." And that is really the issue, and entrepreneurs do want to build big companies that actually become dominant, large providers.

One of the interesting things you see actually even in the M&A market is there are significantly fewer acquirers because there have been no new IPOs. There has been incredible consolidation that actually serves to lower that opportunity. And, again, those are companies that can even be acquired *ex* U.S., with, therefore,

some of the drain of both jobs and innovation outside our borders that we really do not want to have happen.

Let me also go back to Mr. Hiraide's comments about 404(b). I do not disagree with him in spirit. The bill 1933 that is being proposed in the Senate right now, *A,* still requires disclosure of material weaknesses; *B,* the CEO and CFO still certify, and they take that incredibly seriously. And you saw that in responses to our small company survey, they absolutely comply with all corporate governance.

And, again, we are not suggesting that 404(b) does not have value, but if Ford Motor Company gets 2 years, a small startup should get 4 or 5.

Chairman REED. And let me raise another general question, too, and that is, we have talked a lot about stocks, you know, stockholders, the number, *et cetera*. It seems to me—I mean, the question can be raised, this notion of beneficial ownership seems to be outdated if you can have a company like Hyatt that has 100 owners—you know, beneficial ownership versus record owner, 100 owners—we had a few days ago a hearing in which Wawa, which is very well run, prosperous convenience store operation, is a private company, but all their employees are part of some type of stock plan, which is one record owner. So there are thousands and thousands of people that actually have an interest in the stock, yet it is a private company.

Do we have to start thinking beyond just these bills in terms of definition of beneficial ownership? And I would say also accredited investors. Let me ask for Professor Coates' comment.

Mr. COATES. Yes, I completely agree with the idea that before thinking about where to draw the line, we ought to be drawing the line on the right thing. And right now we are drawing the line at record holders, which means one thing for a new company and means something completely different for a public utility that has been around for decades and, therefore, has lots of retail local record holders. So we have got both apples and oranges in the way we are measuring things, and a record holder in the end is going to go away. I mean, by the time we all retire on this panel, it really will be a completely meaningless concept.

So the right thing to do is to think either about beneficial ownership or about public float, which is essentially the same thing but related just to market value of the outside ownership. I would use that as the test.

One last point on this that Barry said a couple times, that private companies do not have intermediaries owning their stock. That may be quite true for lots of private companies. It may be completely true for all the companies that he is familiar with. It is not true generally for the private company universe. Privately held companies that are owned by PE funds, for example, have layer upon layer of intermediaries owning the stock of privately held companies. And so if you want to think more generally about the right way to structure the triggers for Securities Exchange Act registration, I think to stick with record owner is a mistake, as you suggest.

Chairman REED. Mr. Silbert, you want to comment?

Mr. SILBERT. Yes, thank you. There is an important distinction between street name and then whether it is held as a custodian or through a fund like Gates, two different concepts. So I completely agree. Private company stock is held in lots of different places, but it is not held in street name for the purposes of that one broker appearing as one record holder on the books.

Chairman REED. Thank you. Any other comments?

[No response.]

Chairman REED. Once again I want to thank the panel for excellent testimony and very thoughtful responses to questions. Your testimony has provided us critical insights as we grapple with what we recognize as a common challenge, which is to grow jobs here in this country, and to use our securities laws to help facilitate job growth without endangering investors, because there are two sides to every one of these issues, at least.

If my colleagues have their own written statements or additional questions for the witnesses, I would suggest they be submitted no later than next Wednesday, December 21st, prior to Christmas.

I ask unanimous consent to include in the hearing record a summary of State enforcement actions concerning fraud and capital formation in Internet offerings from the North American Securities Administrators Association.

And also a letter from Jeff Lynn from the Coalition for a Digital Economy. Without objection, so ordered.

The witnesses' complete testimony will become part of the hearing record. We ask that any additional questions for our witnesses be submitted no later than close of business next Wednesday, December 21st. And the witnesses are asked to respond to any questions within 3 weeks. I note that the record will close after 6 weeks in order for the hearing record to be prepared for printing.

Thank you again very, very much. With that this hearing is adjourned.

[Whereupon, at 10:55 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

## PREPARED STATEMENT OF JOHN C. COATES IV

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DECEMBER 14, 2011

**Abstract**

Amid an economic downturn caused in part by financial deregulation, it is odd to most people outside the Beltway that Congress should be actively considering (and indeed have passed in the House) a raft of proposal for more financial deregulation. Yet the politics for both parties require efforts to generate job growth, without spending or taxing, and some deregulatory proposals may plausibly do that. The following testimony takes up three themes related to pending proposals to revise securities laws to (among other things) deregulate widely held but unlisted companies and banks, to permit unregistered "crowdfinancing," and to loosen constraints on small public offerings: (1) the proposals under review all raise the same general trade-off, which is best understood not as economic growth *vs.* investor protection, but as increasing economic growth by reducing the costs of capital-raising *vs.* reducing economic growth by raising the costs of capital; (2) no one can with any degree of certainty predict whether any proposal on its own, much less in combination, will increase job growth or reduce it, because the evidence that would allow one to make that prediction with confidence is not available; and (3) the proposals are thus all best viewed as proposals for risky but potentially valuable experiments, and should be treated as such—with an open mind, but also with caution and care. A general suggestion follows: any proposal should contain a sunset, with the SEC directed to study the effects of the proposal during a "test" phase, and authorized to re-adopt the proposals if their benefits exceed their costs. Specific comments on each bill are contained in Part III of the testimony. [JEL classification: G18, G21, G24, G28, G30, G32, G38, K22]

### Introduction

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, I want to thank you for inviting me to testify. Effective and efficient securities regulation is a foundation for economic growth, and I am honored to comment on the topic of protecting investors in the capital-raising process.

In Part I of my remarks, I make three preliminary and general points: (1) the proposals under review all raise the same general trade-off, which is best understood not as economic growth *vs.* investor protection, but as increasing economic growth by reducing the costs of capital-raising *vs.* reducing economic growth by raising the costs of capital; (2) neither I, nor any other witness, nor the SEC, nor any third party, can with any degree of certainty predict whether any proposal on its own, much less in combination, will in fact increase economic growth or reduce it, because the evidence that would allow one to make that prediction with confidence is not available; and (3) the proposals are thus all best viewed as proposals for risky but potentially valuable experiments, and should be treated as such—with an open mind, but also with caution and care. In Part II, I make a general suggestion that could be applied to any of the proposals that are adopted that is in keeping with the need for cautious and careful experimentation. In Part III, I provide responses to specific questions I was asked to address in the invitation to testify, including comments on each of the pending bills.

### I. Growth vs. Growth, Uncertainty, and Experiments

While the various proposals being considered have been characterized as promoting jobs and economic growth by reducing regulatory burdens and costs, it is better to understand them as changing, in similar ways, the balance that existing securities laws and regulations have struck between the transaction costs of raising capital, on the one hand, and the combined costs of fraud risk and asymmetric and unverifiable information, on the other hand. Importantly, fraud and asymmetric information not only have effects on fraud victims, but also on the cost of capital itself. Investors rationally increase the price they charge for capital if they anticipate fraud risk or do not have or cannot verify relevant information. Antifraud laws and disclosure and compliance obligations coupled with enforcement mechanisms reduce the cost of capital.

Each reform bill proposes a different way of achieving growth: lowering offer costs but raising higher capital costs (because of fraud risk and asymmetric information). Whether the proposals will in fact increase job growth depends on how intensively they will lower offer costs, how extensively new offerings will take advantage of the new means of raising capital, how much more often fraud can be expected to occur as a result of the changes, how serious the fraud will be, and how much the reduction in information verifiability will be as a result of the changes.

Thus, the proposals could not only generate front-page scandals, but reduce the very thing they are being promoted to increase: job growth. Suppose, for example, that the incidence of fraud is likely to be higher among issuers that rely on the reforms.[1] If so, and if investors cannot distinguish between new, higher-fraud-risk issuers from the current flow of lower-fraud-risk issuers, the changes may increase the cost of capital for all issuers at a rate in excess of the increase in new offerings facilitated by lower offering costs.[2] There is rarely a truly free lunch in this world.

The reform proposals all present difficult judgments about what will best increase job growth—and not a simple choice between generating job growth versus protecting investors. The trade-offs are highly uncertain, one by one, and even more uncertain in combination. Specific ways the proposals risk increasing the cost of capital to all entrepreneurs are discussed in Part III below. Between them, the SEC, the PCAOB, and FINRA already have authority to enact all or nearly all of the pro-

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[1] This assumption is widely believed. For example, one proponent of a crowdfinancing exemption states, "Small businesses propose a disproportionate risk of fraud." C. Steven Bradford, "Crowdfunding and the Federal Securities Laws", Working Paper (Oct. 7, 2011), at 62. But it is surprisingly difficult to find hard evidence to back up this claim. Bradford cites Jill E. Fisch, "Can Internet Offerings Bridge the Small Business Capital Barrier?", 2 *J. Small & Emerging Bus. L.* 57 (1998) and William K. Sjostrom, Jr., "Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?", 53 *Fla. L. Rev.* 529 (2001). Fisch relies on an SEC Web site that does not provide detailed data, and Sjostrom cites Fisch and Donald C. Langevoort, "Angels on the Internet: The Elusive Promise of 'Technological Disintermediation' for Unregistered Offerings of Securities", 2 *J. Small & Emerging Bus. L.* 1 (1998). Langevoort relies on Louis Loss & Joel Seligman, "Fundamentals of Securities Regulation 301" (3d ed. 1995), who rely on Joel Seligman, "The Historical Need for a Mandatory Corporate Disclosure System", 9 *J. Corp. L.* 1, 34–36 (1983), who relies on the SEC's 1963 "Special Study", which found that of 107 fraud proceedings in 1961 and 1962, 93 percent involved issuers not subject to the Securities and Exchange Act of 1934 (1934 Act), *i.e.,* unlisted issuers, and on a 1980 GAO report finding that in the 3 years ended 1978, in 142 private placements triggered SEC fraud investigations, but the studies do not rigorously compare large and small firm securities offerings. One more recent set of data consistent with the claim is contained in Tables 11, 18, and 25 of Appendix I of the Final Report of the SEC's Advisory Committee on Smaller Public Companies, dated Mar. 3, 2006, available at *www.sec.gov/info/smallbus/acspc/appendi.pdf,* which shows that in 2004 and 2005 the percentage of firms with material weaknesses in their financial reporting control systems was over 20 percent at firms with less than $75 million in market capitalization, as compared to less than 5 percent for firms with greater than $10 billion in market capitalization, the percentage of firms with material weaknesses declines almost monotonically with market capitalization, and also declines (albeit less consistently) with revenues. *See also,* "Separate Statement of Mr. Schacht", at 71 Fed. Reg. 11130 (stating "these small firms . . . make up the bulk of accounting fraud cases under review by regulators and the courts (one study puts it at 75 percent of the cases from 1998 to 2003)," but not providing any reference). Compare Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin, "The Cost to Firms of Cooking the Books", 43 *J. Fin. Quant. Anal.* 581–612 (2008) (Table 2, showing that the incidence of enforcement actions for financial reporting in the period 1978–2002 by firm size, and that the number of actions was similar across firm size deciles, based on all firms in the CRSP database); Natasha Burns and Simi Kedia, "The Impact of Performance-Based Compensation on Misreporting", 79 *J. Fin. Econ.* 35–67 (2006) at 55 (larger firms within the S&P 1500 over the period 1995 to 2002 were more likely to announce an accounting restatement).

[2] The benefits of securities disclosure regulation are articulated and/or evidenced in, among others: Luzi Hail and Christian Leuz, "International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?", 44 *J. Acc'g Res.* 485-(2006) ("firms from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms have a significantly lower cost of capital"); Andrei Shleifer and Daniel Wolfenzon, "Investor Protection and Equity Markets", 66 *J. Fin. Econ.* 3–27 (2002); Allen Ferrell, "The Case for Mandatory Disclosure in Securities Regulation Around the World", *Brooklyn Journal of Corporate, Financial, and Commercial Law* 81 (2007–2008); Allen Ferrell, "Mandated Disclosure and Stock Returns: Evidence From the Over-the-Counter Market", 36 *J. Legal Stud.* 213–51 (2007) (finding that 1964 Securities Acts Amendments reduced volatility and increased returns among OTC firms compared to benchmark NYSE-listed firms); Michael Greenstone, Paul Oyer, and Annette Vissing-Jorgensen, "Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments", 121 *Q.J. Econ.* 399–46 (2006) (finding that OTC firms subject to new disclosure mandates in the 1964 Securities Act Amendments experienced abnormal returns around the passage of the law); *cf.* Robert Battalio, Brian Hatch and Tim Loughran, "Who Benefited From the Mandated Disclosures of the 1964 Securities Acts Amendments?", *J. Corp. Fin.* (forthcoming 2011) (finding no statistical difference in announcement returns for OTS firms moving to NYSE before or after 1964 Securities Acts Amendments and claiming that OTS firms already were disclosing substantial information, but not addressing fact that the SEC "Special Study" that led to the 1964 legislation found that many firms were not disclosing information, that many of those disclosing information left substantial gaps in the information, that disclosures that were being made were not adequately enforced, given that Rule 10b-5 litigation had not developed at the time; the article also inconsistently dismisses nondifferences in NYSE seat prices on the ground that the 1964 legislation was anticipated before its adoption, but treats nondifferences in announcement of NYSE-listings before and after the 1964 legislation as showing the legislation provided no benefit to investors in OTC firms).

posals without a Congressional act. These bills can thus only be understood as experiments in Congressional micromanagement of those agencies, which in general terms have more expertise and resources dedicating to studying the trade-offs than any other group of public officials.

It is true, however, that the agencies would need to get public comments on any of the reforms before adopting them. In the process, they probably would improve the results. But they would take a long time to do that, even in the best of times. And these are times of stress for the financial regulatory agencies as much as for the financial markets. Fewer than one in five of the rules required of the SEC and other financial regulatory agencies under Dodd-Frank have been finalized, and the public is in the middle of commenting on (and the agency staff are still trying to digest comments on) more than 50 pending regulatory proposals from the SEC alone.[3] Congress did not give the SEC self-funding authority in Dodd-Frank, and as a result, the SEC is budget-constrained,[4] and cannot devote the resources that would be ideal to trying to move towards smarter regulation.

(This is a point that those who oppose "active" regulatory agencies often miss—the same procedures and budget constraints that slow or deter regulation also slow and deter deregulation or improved regulation. Congress could fix this by giving the SEC the same self-funding authority it has given to the Federal Reserve Board, or by requiring the SEC to devote a portion of its budget to deregulatory proposals, or simply by giving the SEC enough funds that it has no excuse for moving slowly on reform proposals. Even if one of these proposals were implemented, however, the Administrative Procedures Act (APA)[5] would mean that the SEC would move slowly on any reform proposal in any event.)

In addition, finally, the agencies would have also to worry about being sued. In recent years, it has become an almost predictable ritual that any new and controversial rulemaking by the SEC will attract litigation by trade groups that perceive their members as having been disadvantaged by the rule, even for what distant observers would view as "deregulation." Frequently, the SEC has lost this litigation,[6] at times on grounds that have been in my view legally dubious.[7] Knowing that

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[3] *See,* Davis Polk Regulatory Tracker, "Dodd-Frank Progress Report" (Dec. 1, 2011), at 4–5.

[4] In 2011, the SEC was allocated $115 million less than its budget request, and was able to hire staff for 342 fewer full-time equivalent positions than it sought to do, despite taking in more than its request in fees. Compare U.S. Securities and Exchange Commission, FY2011 Congressional Justification (Feb. 2010) (*www.sec.gov/about/secfy11congbudgjust.pdf,* last visited December 11, 2011) at 8–9, with U.S. Securities and Exchange Commission, FY2012 Congressional Justification (Feb. 2011) (*www.sec.gov/ about/ secfy12congbudgjust.pdf,* last visited December 11, 2011), at 9–10.

[5] 5 U.S.C. §551 *et seq.*

[6] *For example, Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006) struck down a SEC rule requiring registration of hedge fund advisers under Advisers Act); *Financial Planning Assoc. v. SEC,* No. 04-1242 (D.C. Cir. Mar. 30, 2007) struck down a SEC rule exempting broker-dealers from Advisers Act despite receiving "special compensation" if "incidental" to brokerage; PAZ Securities, *Inc. v. SEC,* No. 05 1467 (D.C. Cir. July 20, 2007) struck down an SEC order affirming expulsion of a NASD-member firm and barring its president from the securities industry for failing to comply with various examination requests; *American Equity Investment Life Ins. Co. v. SEC,* 613 F.3d 166 (D.C. Cir. 2010) struck down a rule treating a new class of annuities as securities; *Chamber of Commerce v. SEC,* 412 F.3d 133 (D.C. Cir. 2005) struck down a rule mandating proportion of independent directors on mutual fund boards.

[7] The D.C. Circuit's recent decision striking down the SEC's "proxy access" rule is a case in point. *Business Roundtable v. SEC,* 647 F.3d 1144 (D.C. Cir. 2011). Despite the SEC having debated the issue for over a decade, developed an extensive public record before enacting Rule 14a-11, and adopted the rule under the explicit authority and implicit direction of Congress in Section 971 of the Dodd-Frank Act, a panel of the D.C. Circuit struck the rule down as "arbitrary and capricious" on the ground that the 25 single-spaced pages devoted to cost-benefit and related analyses in the adopting release was inadequate under the APA and "failed . . . adequately to assess the economic effects of a new rule." The D.C. Circuit failed to acknowledge that there is no currently available scientific or other technique for the SEC to "assess the economic effects" of the rule along the lines that the Court seemed to think legally required—as when the Court held that the SEC "relied upon insufficient empirical data when it concluded that Rule 14a-11 [would] improve board performance and increase shareholder value by facilitating the election of dissident shareholder nominees," at 1150, or when it held that the SEC had "arbitrarily ignored the effect of the final rule" because the SEC "did not address whether and to what extent Rule 14a-11 will take the place of traditional proxy contests," at 1153. Instead, the D.C. Circuit substituted its own judgment for that of the SEC in evaluating the existing research relevant to proxy contests, going so far (for example) as to characterize (without explanation) a peer-reviewed article published in the *Journal of Financial Economics* as "relatively unpersuasive." At 1151. This result was clearly not intended by Congress in adopting the APA, and is clearly inconsistent with decades of precedent under that statute, including a 2005 decision by the same court, *Chamber of Commerce v. SEC,* 412 F.3d 133 (D.C. Cir. 2005),

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court scrutiny of this kind is likely even when an agency advances a modest but controversial reform would make any regulatory agency rationally reluctant to move quickly, and instead will lead it to act deliberately to pile up as impressive a record as possible to present in the expected litigation.

As a result, given the urgency of the political and economic situation, and given that no more straightforward jobs proposal seem to be acceptable to both parties, it is understandable why these experiments are being proposed now, despite their already being underway SEC studies of several of the proposals, and despite the uncertainties they raise. It would also be understandable if lawmakers ultimately choose to act now, and not wait on agency action. But if it does that, it should do so with the uncertainty about the growth-growth trade-offs presented by the reform experiments in mind.

**II. A General Suggestion**

Given that any of these proposals will entail risks of increasing fraud and capital costs, even if modified as I suggest in Part III below, or as suggested by others, it would make sense to include in all of the adopted proposals a sunset provision, such that the proposals would by their terms last for no more than 2 or 3 years (or, in the case of S. 1933, 7 years). At the end of that testing period, they would remain in place if—but only if—the SEC affirmatively finds that the benefits of continuing the proposals would outweigh their costs. During the testing period, the SEC would be able to complete its currently underway studies, as well as track the use of the new capital-raising options, as well as the extent of fraud that they permit. If the fears of fraud are overblown, and capital has been raised as their backers suggest will be the case, then the cost-benefit analysis should be simple, and the reforms would become permanent. If, however, large amounts of fraud occurs in the test phase, or if even a modest amount of fraud occurs but the reforms do not permit meaningful amounts of new capital-raising, then the agencies might not be able to conclude their benefits outweighed their costs, and the reforms would end.

To be practical, this suggestion might in some cases involve grandfathering market participants, as well as simple and inexpensive notice provisions to allow the agencies to track the use of the reforms, as already reflected in the crowdfinancing proposals. The reforms could be tested in this way individually, so that some could remain in place and other not.

The advantage of the sunset approach would be to generate at least some of the information that would be needed to evaluate the reforms, to allow the reforms to be used but only for a modest time before that evaluation is completed, to allow for capital raising in the short-term, while the economy is stressed, and allow for a measured revisiting of the reforms once (we all hope) the economy has returned to a more normal state. Congress could, of course, reenact the reforms on a permanent basis if it disagrees with the agencies.

**III. Specific Responses and Comments**

The following remarks respond to comments in the invitation to testify:

*1. What factors influence the timing and extent of an issuer's access to the capital markets? How does investor confidence impact markets? What factors contribute to a high degree of investor confidence in the securities markets?*

The extent and timing of an issuer's access to capital markets depends on both demand and supply side factors. On the demand side are the number,[8] wealth,[9] intelligence,[10] liquidity- and risk-appetites, and confidence of investors, which affects market liquidity,[11] as well as the attractiveness of opportunities to spend or invest their money elsewhere. On the supply side, the foremost factors are those that make a given issuer a potentially good investment: the quality of the issuer's management, business plan, and its growth prospects, *etc.* But other supply side factors are important, include the legal protections afforded investors (including both the laws and the enforcement mechanisms for those laws),[12] the information required or vol-

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which held at 143 that the SEC need only "determine as best it can the economic implications" of a rule to be upheld under the APA.

[8] Yakov Amihud and Haim Mendelson, "Asset Pricing and the Bid-Ask Spread", 17 *J. Fin. Econ.* 223–249 (1986) (liquidity increases firm value and lowers its cost of capital).

[9] Annette Vissing-Jorgensen, "Limited Asset Market Participation and the Elasticity of Intertemporal Substitution", 110 *J. Pol. Econ.* 825–853 (2002).

[10] Mark Grinblatt, Matti Keloharju, and Juhani Linnainmaa," IQ and Stock Market Participation", 66 *J. Fin.* 2121–64 (2011).

[11] *E.g.,* Pankaj K. Jain and Zabihollah Rezaee, "The Sarbanes-Oxley Act of 2002 and Capital Market Behavior", 23 *Contemp. Acc'g Res.* 629–54 (2006).

[12] La Porta, *et al.,* "What Works in Securities Laws?", 61 *J. Fin.* 1–32 (2006), at 20 (in a cross-country study, laws mandating disclosures and public enforcement of those laws "has a large

untarily disclosed to investors,[13] including by way of analyst coverage,[14] and the direct offering costs of raising capital from investors.

The largest single direct offering cost for any public offering is usually the cost of hiring underwriters—which almost uniformly charge 7 percent for initial public offerings in the U.S., as compared to 4 percent in the EU.[15] Offering costs also include those that are the focus of the pending reform proposals: legal, compliance and audit costs, both for the offering and on an ongoing basis as a result of laws triggered by capital-raising on the markets, which can be significant, particularly for smaller issuers. As noted, however, a reduction in these costs can be more than offset in an increase in capital costs, if the reduction in direct offering costs decreases investor confidence or the content or reliability of information required by investors.

*2. What legal, financial, and practical risks do companies face when offering securities through the Internet or other social media?*

In general, the use of the Internet and social media do not in my view dramatically change the risks that companies face when offering securities from the risks that are present whenever the public is solicited to invest, except that offers via Internet and social media are able to reach a much larger potential investor group more quickly, and without care and expense, their Internet-based efforts will be treated (as they should be) as a general solicitation covered by Section 5 of the 1933 Act. I discuss the effects of the Internet more particularly below, in the context of commenting on the crowdfinancing proposals below.

*3. What risks do investors face when investing in publicly held securities?*

The economic risks include fraud, expropriation, and loss of investment, risks present in any investment. Many investors also fall prey to the illusion (sometimes reinforced by luck) that they can safely trade in and out of publicly held securities on a frequent basis, not focusing on the dramatically negative effects that frequent trading by uninformed or poorly informed investors typically have on their total returns over time. The risks are generally lower for publicly held securities, because the investments are liquid, because the issuers are required to make disclosures, reviewed by the SEC staff, because the issuers are subject to greater compliance obligations, and because more public enforcement resources are devoted to public companies than to private companies. Nevertheless, the risks remain.

*4. What investor protections (*e.g.*, basic disclosures, liability,* etc.*) should exist when securities are sold to investors in public or private markets? Should those protections vary with the size of the offering, whether they are public or private, and whether they are offered to mainstream investors or accredited investors?*

Investors should receive the most efficient bundle of protections that trades off the marginal cost of capital-raising, which represents the cost of those protections, against the marginal cost of capital, which is determined in part by the value of those protections. The precise configuration of protections is likely to vary across investments, investor dispersion (widely held *vs.* closely held), firm and offering size, and the nature of the investors. In general terms, the current SEC approach makes sense: generous exemptions and relatively light requirements for securities privately placed with qualified institutional buyers, narrow exemptions and heavier requirements for securities sold to the dispersed and often unsophisticated retail investors. One observation is that in my view the current "accredited investor" test is too weak—too many nominally accredited investors obtain the wealth that qualifies them as such in ways that do not reflect any ability or training to invest wisely (*e.g.*,

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economic effect" making initial public offerings more common); Luzi Hail and Christian Leuz, "International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?", 44 *J. Acc'g Res.* 485-(2006) ("firms from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms have a significantly lower cost of capital"); Dan S. Dhaliwal, "Disclosure Regulations and the Cost of Capital", 45 *So. Econ. J.* 785 (1979) (adoption of additional disclosure requirements lowered the cost of equity capital for covered firms).

[13] S. Myers and N. Majluf, "Corporate Financing And Investment Decisions When Firms Have Information That Investors Do Not Have", 13 *J. Fin. Econ.* 187–221 (1984); D.W. Diamond and R.E. Verrecchia, "Disclosure, Liquidity and the Cost of Capital", 46 *J. Fin.* 1325–59 (1991).

[14] Darren T. Roulstone, "Analyst Following and Market Liquidity", 20 *Contemp. Acc'g Res.* 551–78 (2003) (more analyst coverage increases liquidity, which lowers the cost of capital).

[15] Mark Abrahamson, Tim Jenkinson, and Howard Jones, "Why Don't Issuers Demand European Fees for IPOs?", 66 *J. Fin.* 2055–82 (2011). Data from Renaissance Capital shows that the median annual U.S. IPO raised between $94 and $157 million in the 2000s (see, *www.renaissancecapital.com*, last visited Dec. 8, 2001). Thus, $7 million were typically paid to the underwriters in the typical U.S. IPO in recent years. Average underwriter fees were more than twice as high, due to some large issuers (*e.g.,* General Motors) pulling up the average offering size. Total legal, audit, and compliance costs for an IPO, by contrast, are reported to be $2.5 million. IPO Task Force, Rebuilding the IPO On-Ramp, Presented to the U.S. Treasury (Oct. 20, 2011).

inheritance, gifts, high salaries for talented young athletes). It would be better if the SEC took more seriously the job of dividing knowledgeable investors from others, through the use of tests—such as we require for everyone to legally drive, and create incentives for those who cannot or do not have the interest in so qualifying to invest through intermediaries, such as diversified mutual funds.[16] Congress could direct the SEC to do so.

*5. Do secondary market investors face risks different from those who purchase securities primary offerings? How does the availability of information in the secondary market affect liquidity and price?*

Yes, the risks are different in secondary and primary offerings. In a primary offering, there is usually no prior market price, and investors must decide on a price on their own, based on their due diligence and information received from the company. In a secondary offering, at least one in a genuinely liquid market, a new investor can rely to an extent on prior market prices to at least simplify the task of price formation. Of course, secondary market prices can be manipulated, particularly if the market is illiquid, and secondary market prices are only as good as the information on which the prior trades were based. More and better information typically increases liquidity and price.

*6. How would current legislative proposals affect investors? What changes, if any, should be considered in these proposals?*

The proposed reforms fall into four categories: (1) crowdfunding (S. 1791 and S. 1970); (2) small offerings (S. 1544); (3) 1934 Act registration triggers (S. 556, S. 1824 and S. 1941); and (4) initial public offerings (IPOs) (S. 1933). I address each in turn.

*1. Crowdfunding*

The one genuinely new reform proposals on the table relate to crowdfinancing. Modeled on crowdsourced volunteer successes such as Wikipedia, person-to-person lending platforms such as Prosper Marketplace, Inc.,[17] and crowdfunded (but not financed) schemes for authorship or ownership rights to new music, plays, and discrete products (but not securities or investments), such as Kickstarter,[18] crowdfinancing promises to allow for entrepreneurs otherwise unconnected to conventional early-stage financing sources (family, friends, angels) to connect through the Internet to "investors" who would be willing to risk small amounts to strangers for the hope of angel-investments-like returns. For fans of the Internet, and for entrepreneurs unable to raise capital in other ways, would-be crowdfinanciers make an appealing pitch. Proponents add a dash of anti-Wall-Street and/or Silicon Valley sentiment—crowdfinancing will enable the common man to avoid entanglements with the corrupt traditional centers of capital formation—and then point to a handful of experiments in other countries to show that the model can work.

The entirety of the crowdfinancing concept suggests nothing to me so much as a catchy, high-risk, and very possibly fraudulent investment scheme. It might work. It might turn out to be a neat new thing. Or it might turn out to be mostly a cheaper, better vehicle for fraud, with negative spillover effects on the current person-to-person lending and crowdfunding project sites. Let me sketch some reasons to be cautious about crowdfinancing *per se,* as opposed to crowdsourced lending or product funding or social entrepreneurship.

From the perspective of the honest entrepreneur, what does crowdfinancing promise? Given the limits that all crowdfinancing proposals currently include—particularly the cap of $1 million per firm—the funds you can obtain this way will practically only benefit a limited class of entrepreneurs—those working on low-capital-expenditure, low operating-expenditure projects (such as software products) that can be produced with sweat equity, a laptop, bandwidth, and a coffee maker. Still, these firms may find the prospect of cheap financing attractive, and the past 20 years have demonstrated repeatedly that such firms can create real value.

Nevertheless, creators of such firms should think carefully before moving to crowdfinancing. Without significant investment of time on your part to screen investors, a host of strangers will end up owning a chunk of your company. You will have obligations to them as a fiduciary. Among them may be competitors, gadflies, journalists, cranks, and crooks. They will have rights to get information from your firm. They have standing to sue you. True, their rights are practically useless to them in protecting their legitimate interests as shareholders, but they can cause havoc

[16] Stephen Choi, "Regulating Investors, Not Issuers: A Market-Based Proposal", 88 *Cal. L. Rev.* 279 (2000).

[17] On person-to-person lending, *see,* Andrew Verstein, "The Misregulation of Person-to-Person Lending", 45 *U.C. Davis Law Review* (forthcoming, 2011), available at *http://ssrn.com/abstract=1823763.*

[18] On crowdfunded projects, *see,* Paul Belleflamme, *et al.,* "Working Paper" (June 2011), available at *http://ssrn.com/abstract=1578175.*

in your already overworked schedule simply by making demands or filing a complaint. Almost by definition, they will be good at using the Internet to retaliate—with gossip, rumors, exaggerations, or lies—if you treat them in ways they do not think appropriate. If you succeed, their expectations will soar, and if as is likely you eventually sell more equity—to a venture capital fund, for example—you will likely need to cash out the crowdfinancing investors in order to get the venture capitalists to come in. If you ever need them to commit to a lock-up agreement or otherwise facilitate an initial public offering, good luck trying to get them all to agree. (Contrast this with person-to-person lending, where the recipient receives cash in return for a fixed repayment obligation, no different in kind than a credit card, that can generally be paid off at any time.)

From the perspective of investors, crowdfinancing should be understood as an act of faith, at least as it would play out under S. 1791. Investors would have no practically effective ways to collect any return on their investment, except to the extent shares could be sold to some other investor equally or more optimistic or irrational or charitable or profligate, depending on one's point of view.

Under S. 1791, securities regulators will have no ex ante role to play in reviewing disclosures. *Ex post* fraud liability, even if the heightened standards normally applied under the 1933 Act were applied, would do little to protect against such ordinary corporate transactions as recapitalizations at a low price, low-price mergers with companies controlled by the entrepreneurs, asset sales at a low price, or high compensation reducing to nearly zero any cash flow that the firm were to generate. While such actions might be actionable as breaches of fiduciary duty under corporate law, they would not likely constitute "fraud" in the narrow sense that courts have interpreted Rule 10b-5. As a practical matter, the small amount of money to be invested by any one crowdfinancier would make a private corporate law suit cost-prohibitive, and no self-respecting class action plaintiffs' attorney could be relied upon to know about much less police start-ups that are too small to even be called "microcap."

Unlike crowdfunded products, where a song or other computer-based good can be obtained and its quality verified, investments take time to grow in value, are constantly fluctuating in value, and are inherently based on future—indeed, the standard finance model of the value of a stock is to project future cash flows generated by the firm that has sold that stock. Unlike person-to-person lending, where the borrower has immediate interest or repayment obligations that can be monitored cheaply, the entrepreneur receiving a crowdfinanced investment will have no fixed obligations unless and until the firm is sold or liquidated, before which time many corporate finance transactions can rewrite the terms of the deal on a difficult-to-police basis.

While it is possible to imagine an honest entrepreneur using crowdfinancing to generate a firm of great value and then, out of honesty, sharing that value with the initial investors, a well-advised investor would have to recognize that such outcomes will depend almost entirely upon the character of the entrepreneur. While crowdfinancing is unlikely to reach the scale to cause any serious systemic financial problems, it would be well to remember that in the last financial bubble, "liar's loans" were a common way for borrowers to obtain a mortgage—essentially loans based on character. That method of finance did not turn out so well.

In sum, crowdfinancing should be recognized as a long shot for both entrepreneurs and investors alike. It might work, in very limited contexts, if the participants have some social or other extra-legal reason to trust one another, and to fulfill that trust. To the extent crowdfinancing genuinely is meant to resemble its predecessors in the Internet space, the investments would be made by numerous investors (contrary to the usual angel or venture capital model) who nevertheless know and vet each other through an existing and ongoing online community, who can identify each other in a verifiable way (and so weed out sock-puppets and shills) and can communicate with one another about their common investments, rely on each other for information and advice, and would only make small diversified investments with specific safeguards, such as an escrow account into which investments would be placed until a designated project amount was reached—the idea being that no one investor's money would be used until the project had been "approved" by virtue of a large number of other investors committing their money. And at the end of the day, the investors would make their investments knowing, in effect, not simply that the investments were "risky" or even "highly risky," but near-charitable donations that might produce a windfall—more akin to a lottery than anything else.

While we can rely to an extent on reputation to substitute for law in some contexts, and crowdfinancing intermediaries might be able to develop and impose similar rules of the road on participants, we can also count on some intermediaries to not do that extra work, and to try to generate revenues in the short run on the

hopes and dreams of entrepreneurs and investors alike. When they do, and when the conflicts and fraud emerge, the effects will spill over onto the otherwise legitimate crowdfinancing intermediaries, and will further spill over onto firms already successfully operating person-to-person lending platforms and crowdfunded product platforms. In some ways, those firms have the most to lose from an ill-considered experiment with crowdfinancing.

Moreover, the limits that are currently in S. 1791 are not practically enforceable. While individual investments are limited to $1,000 per year, and any one firm can only raise $1 million in a year, there is no mechanism required of issuers, investors, or crowdfinancing intermediaries to verify whether the individual has complied with the limit, other than the vague requirement that intermediaries "take reasonable measure to reduce the risk of fraud." (Even under current rules, requirements that "accredited investor" status be verified are weak at best, with investor self-certification and a short delay sufficing at many online stock-trading platforms.) Even if we did not feel sorry for investors who lied their way into a crowdfinanced Web site, a fraudster could set up multiple fraudulent firms and attract multiple investments of $1,000 each, greatly exceeding the savings of most typical Americans.[19] When that fraud is uncovered, all Web-based financing efforts are likely to lose reputational capital, even the diligent ones that do a good job of screening and monitoring investors and entrepreneurs.

In contrast, the requirements of S. 1970 are more robust, and more likely to prevent reputational spillovers of fraudulent crowdfinancing schemes onto legitimate Internet based financial firms. By building in express authority for the SEC to condition intermediary status on various forms of investor protection, S. 1970 is a more thoughtful delegation of difficult implementation issues. However, let me caution that—as noted above—the current litigation climate affecting all SEC regulation means that the SEC's ability to act on its authority cannot be taken for granted. Thus, I would condition any sales under the crowdfinancing exemption upon prior SEC rulemaking that is currently in effect, so that if the rules were to be struck down by a court, the exemption too would fall. And, as noted above, I would suggest having any crowdfinancing exemption sunset by its terms after 2 or 3 years to permit a careful review of how it is being used, before permitting it to continue.

*2. Small Offerings*

The effort to reinvigorate Regulation A small offerings represented by S. 1544 strikes me as neither promising nor threatening. It is not particularly threatening (to capital costs or investor protection) because without blanket preemption of State blue-sky laws, it is unlikely to be used. It is not promising for the same reason, and because Regulation D coupled with Rule 144A and innovations such as SecondMarket make the small offering path to capital formation both unattractive for policy reasons (why invite middle class investors to invest with the least protections?) and practical reasons (if a firm cannot raise funds from qualified institutional buyers, how likely is it that a firm could do so from unaccredited investors—other than by misleading them?).

If enacted, and particularly if a blanket blue-sky preemption clause were included or added later, it seems to me that moving from $5 million to $50 million in one swoop is unnecessarily risky, dramatically so in light of its reduced liability standards relative to conventional public offerings, and even more so if Section 12(g) triggers are raised, as separately proposed. Even though a good case can be made for reducing disclosure, audit, and compliance costs for smaller companies selling shares to the public, relative to large existing public companies, this is better addressed by S. 1933, and there is no clear reason to reduce the disclosure and liability standards applicable to any public offering in which hundreds of unaccredited investors are asked to speculate simultaneously on an unproven technology and a control-free cash management system. If S. 1544 is adopted, I would combine the use of a sunset clause suggested above with a more gradual approach to the amount: begin with a $15 or $25 million exemption, which would revert to $5 million if the SEC did not find that the higher threshold met a cost/benefit test, and condition any further increase on a similar subsequent testing phase, sunset, with review and reapproval by the SEC. In addition, caution with this experiment would also suggest adding an all-time fund-raising cap that integrates all offerings under this modified exemption over time, and also integrates it with offerings under Regulation D, rather than simply capping the amount that can be raised in 1 year. Without those changes, the combination of Regulation A and manipulation of the "record

[19] "A 2010 survey found that 30 percent of all [American] adults had no savings (excluding retirement savings). . . . Forty-nine percent of . . . respondents [to another survey] found it difficult merely to pay all of their bills each month." Bradford, *supra* n. 1, at n. 581.

holder" formality under current Section 12(g) could open up a path to complete evasion of public registration requirements, which would not be in keeping with the idea of a "limited" or "small" offering exemption.

*3. 1934 Registration Triggers*

Two of the pending bills propose raising the triggers for 1934 Act registration from the current 500 record holder trigger, one for banks, one for all companies, and, in addition, to exempt employee owners from counting towards the trigger. In my view, these are the riskiest proposals being discussed. Raising the cap to 2,000 record holders would allow more than half of all public companies to go "dark."[20] This might be a boon to some companies, which could immediately cut compliance costs. But for investors who have already invested in the suddenly much larger number of firms that could "go dark," such a radical change would upset legitimate investment expectations, and have spillover effects on liquidity, capital costs, and value of the firms that choose to "remain lit."[21] Particularly if combined with permission for private offerings to target the public in general solicitations, as in S. 1544, raising the Section 12(g) limit in this way would effectively gut the securities laws for all but the largest issuers. Such a dramatic change would, if proposed by the SEC, almost certainly generate a great deal of comment and discussion, and rightly result in an extensive public debate. Does it make sense for the Congress to rush in radical deregulation on the hope that it might generate short-term job growth?

If the objection of proponents to public registration under the 1934 Act centers on control systems and compliance costs, the better path is that represented by S. 1933—and also even more straightforwardly by demanding that the PCAOB use its existing authority to tailor the requirements under Section 404(b) of the Sarbanes-Oxley Act as applied to smaller or newer companies. The objection may, however, be primarily about wanting to keep investors in the dark about executive compensation, corporate governance, insider trading, proxy manipulation of the kind documented at over-the-counter companies in the SEC's 1963 Special Study,[22] conflict of interest transactions, earnings "management," capital expenditures, and other ways in which investors and their money can be misused. Perhaps the reduction of capital-raising costs entailed by such changes is worth trading off against the increased cost of capital for widely held firms generally, on an experimental basis.

But if so, a better case needs to be made than the one thus far presented by advocates, who simply repeat the talking point that the 500 record holder limit is "out of date." Advocates do not ever explain why dispersed investors today are any less in need of strongly enforced disclosure laws, or better capable of protecting themselves without such laws, than they were in 1964. (By contrast, it makes obvious sense that the asset trigger in the 1934 Act would need to be raised, to reflect growth in the economy and average investor wealth.) Ample research shows that dispersed shareholders remain usually unable to easily or cheaply use their existing rights to protect even their most basic rights to elect the boards of directors of the companies in which they invest.

Carving out employee ownership of stock would at least be consistent with SEC exemptions or no-action positions on options and restricted stock units. However, it is unclear why employees are less in need of information and antifraud protection than outside investors. While they are in a good position to monitor some aspects of a firm, and equity ownership is clearly an incentive tool for many companies, particularly cash-constrained firms, such as start-ups, few employees have access to or an ability to check the members of the C-suite, and the fact that their investments represent a doubling down on the human capital investment they have in the form of firm-specific knowledge and relationships built up in their employment has long meant that employee investors are peculiarly exposed to the investment risks represented by employer stock. Some of the current use of employee stock or stock op-

[20] John C. Coates, "The Powerful and Pervasive Effects of Ownership on M&A", Working Paper (June 2010), available at *http://ssrn.com/abstract=1544500* (last visited December 12, 2011). In that paper, I find that over a third of all firms in Compustat have fewer than 300 record holders, and that the median number of record holders of such firms in 2007 was 700.

[21] While some researchers have noted that many firms choose to go "dark" when they are forced to comply with new disclosure requirements, see Brian J. Bushee and Christan Leuz, "Economic Consequences of SEC Disclosure Regulation: Evidence From the OTC Bulletin Board", 39 *J. Acc'g and Econ.* 233–264 (2005), few have noted that over a third of public firms large enough to be included in databases such as Compustat have fewer than 300 record holders, and thus can be thought of the reverse of firms that have "gone dark"—firms that have chosen to "stay lit," presumably because the lower cost of capital produced by effectively enforced securities laws is worth the lowered cost of compliance that being private would permit.

[22] *See*, generally Seligman, *supra* note 1.

tion compensation is generated by tax incentives similar in kind to the mortgage interest deductions—seemingly attractive ideas that are in need of rethinking.

A better case can be made to raise the limits in this fashion for banks, since they are directly regulated by bank regulatory agencies and are required to file call reports and make other disclosures to depositors, which equity investors can also access. However, these disclosures may not be widely known to many bank investors, and if the goal of S. 556 is in fact to permit the continued family or community ownership of community banks without triggering SEC registration, it would be better to develop tailored exemptions for ownership by direct or indirect heirs, or community-based owners geographically proximate to the bank with some long-standing depositor or other relationship to the bank, to increase the odds that the investor has information about and can protect their interest in the issuing bank.

Finally, it should be emphasized that the current use of "record holders" as a trigger for 1934 Act reporting is in fact "out of date," not because of the number 500, which while arbitrary seems reasonable as a measure of "dispersion" of shareholders, but because of the use of "record holder" as the thing to count. As others have previously testified, the methods of distributing equity have long made the use of record ownership an anachronism. While record holder counts correlate with beneficial owner counts, they do so weakly, and increasingly weakly, over time. Firms that make disclosures to their shareholders already have beneficial owner counts, in order to know how many annual reports or proxy or information statements to provide to record holders to pass through to beneficial owners, and it has long been a puzzle to outsiders why the SEC has not moved to using beneficial ownership as the relevant metric. To be sure, there are many beneficial owners who object to having their identities known to a company, but it is hard to see why any beneficial owner would object to being counted for disclosure purposes. To be sure, there are fluctuations in beneficial owner counts, and they are probably measured with more noise and greater lags than record holder counts, but the rules could allows firms to rely upon record holder reports of beneficial owners as of a certain date, eliminating such uncertainties for issuers' legal obligations. Alternatively, one could imagine moving to a "public float" trigger measured by reference to value of unaffiliated investments, rather than counts of outside investors, as others have suggested. However, doing so will increase to some extent the arbitrariness of the test, since it will focus less on ownership dispersion—which presumably is the theoretical reason that investors cannot be counted on to demand information on their own—and more on market valuations, which can vary rapidly without regard to the relative power or information needs of investors. Nevertheless, either method of counting would be great improvement over the current trigger, which effectively rewards well-advised firms who carefully structure their investors' investments in order to keep their nominal record holder count down, and punishes older firms like Wawa, Inc., which has long done the more straightforward thing and issued stock to employees as holders of record.

*4. IPOs*

Last, I address S. 1933, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011." This bill is the most thoughtful and carefully structured bill being considered, and (with two caveats, discussed below) raises the fewest risks. While I would shorten the start-up period to 4 years, rather than 5, and couple it with a sunset—after 6 or 7 years, rather than 2 or 3 as for the other proposals, in order to let the 4-year ramp-up period play out—I believe that the relatively modest reductions in investor protection that it would permit pose the least risk to the current regulatory system while holding out the promise of at least some meaningful nonfraudulent capital formation.

To be sure, I am not sure that the bill will dramatically increase the number or reduce the size of IPOs, as advocates of this reform seek to do, or whether IPOs are as central to job creation as the investment banking community would like to believe. While a case can certainly be made that compliance costs have impeded marginal firms in the last 10 years, the fall-off in IPOs began well before Enron, much less Sarbanes-Oxley, and microcap firms have never been subject to Section 404(b) of that law, yet there has been no resurgence of IPOs by 404(b)-exempt firms, even after the exemption for microcap companies was made permanent. More serious impediments to a renewals of IPOs, it seems to me, include the increased "deretailization" of the equity markets, which in many respects is a good thing, as retail investors have increasingly realized that they are the most likely to make poor investment decisions, and have increasingly come to rely not on broker-dealers paid to generate value-destroying churn, but on fee-only advisers, particularly advisers to mutual funds and other regulated collective investments, who in turn increasingly invest through private equity funds. Institutions seek not just investments but

liquidity depth, making smaller or thinly traded IPOs that might once have attracted a retail investor following unlikely to generate the same interest from the institutions that now bundle those investors' dollars and invest collectively. Where the institutions are content without that liquidity, they have Regulation D and Rule 144A, which permit issuers to raise a great deal of liquid capital from dispersed institutional investors without going public.

Nevertheless, there probably are at least some firms that would be able to reduce their capital costs by going public, that are nonetheless deterred by the marginally higher offering costs generated by 404(b) and other disclosure requirements. Thus, the bill may do some good. Because the firms would still need to meet all of the other requirements of the 1933 and 1934 Acts, including obtaining audited financial statements (albeit for a reduced period), and because the sponsors would remain subject to the full liability regime of the securities laws, the risks of the deferral of some of the disclosure obligations under the 1934 Act seem appropriately small, and worth taking, particularly because the result is to increase the amount of publicly traded securities, with spillover liquidity benefits for other firms.

I add two caveats. First, I have not had a chance to think carefully about the provisions of the bill that relate to research analysts. They are modestly complex, as they require thinking through the potential conflicts of interest between underwriters, dealers, and firms issuing research, under both the SEC's rules and the rules of FINRA. Analyst coverage is clearly a key linch-pin in developing a liquid market for a prospective public company, but analysts, too, have played a sad role in recent bubbles, particularly in the build-up of telecoms in the late 1990s and early 2000s. The bill proposes to explicitly and clearly take away authority from the SEC and FINRA to regulate analysts in the IPO context, and it is not clear to me—and, since this bill was introduced only 10 calendar days ago, I suspect it is not clear to anyone other than the sponsors and those who advise them—whether this narrowing of regulatory authority makes sense, or is necessary, in its current form, to accomplish the legitimate goal of increasing analyst coverage of newly public firms. Second, I would have thought a more straightforward way to accomplish at least the goal of reducing SOX 404(b) costs would be to command the SEC and the PCAOB to use their authority to better tailor the compliance, audit, and attestation requirements for newly public companies.

Spurring regulatory innovation is one of the most important tasks Congress has. One way to do it is to deregulate and hope for the best. Another way to do it is to command the agencies to regulate in a more sensible way, with explicit metrics to show that it has worked. For example, Congress could require the agencies to take action within a set period of time to modify the SOX 404(b) requirements, and then report on the effects on compliance costs using surveys of firms. If the costs had not come down, the agencies would be required to go further. While this would take time—and not generate any new jobs before the next election—it would be more likely to produce an efficient trade-off between capital-raising costs and capital costs than the cycle in which we seem to be currently stuck: deregulating, hoping for the best, and then rushing to reregulate after the next scandalous financial collapse.

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## PREPARED STATEMENT OF KATE MITCHELL

MANAGING DIRECTOR, SCALE VENTURE PARTNERS

DECEMBER 14, 2011

Chairman Reed, Ranking Member Crapo, my name is Kate Mitchell and I am a managing director at Scale Venture Partners, a Silicon Valley-based venture capital firm that has investments in information technology companies across the United States. Venture capitalists are committed to funding America's most innovative entrepreneurs. We work closely with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. We believe that IPOs drive job creation and economic growth because, as our data show, 92 percent of a company's job growth occurs after its IPO.

I am also a former chairman and current member of the National Venture Capital Association. Companies that were founded with venture capital accounted for 12 million private sector jobs and $3.1 trillion in revenue in the U.S. in 2010, according to a 2011 study by IHS Global Insight. That equals approximately 22 percent of the Nation's GDP. Almost all of these companies, which include Apple, Cisco, Genentech, and Starbucks, began small but remained on a disciplined growth trajectory and ultimately went public on a U.S. stock exchange.

More recently, I served as chairman of the IPO Task Force, a private and independent group of professionals representing the entire ecosystem of emerging growth companies—including experienced CEOs, public investors, venture capitalists, securities lawyers, academicians and investment bankers. This diverse coalition came together initially as part of a working group conversation at the U.S. Department of the Treasury's Access to Capital Conference in March 2011, where the dearth of initial public offerings, or IPOs, was discussed at length. In response to this shared concern, we formed the IPO Task Force to examine the challenges facing America's troubled market for IPOs and make recommendations for restoring effective access to the public markets for emerging growth companies.

Our task force developed our proposals based on a consensus approach that considered, and in many cases rejected, a variety of possible approaches. We left behind many ideas based on the valuable input we received from the variety of interdisciplinary perspectives that our membership represented. We released our report, "Rebuilding the IPO On-Ramp", in October of this year. We shared our findings and recommendations with Members of Congress and the Administration, including the Treasury Department and the Securities and Exchange Commission (SEC). I have submitted a copy of this report along with my written testimony today.

On behalf of the diverse members of the IPO Task Force, I am here today to support S. 1933, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011." This bipartisan legislation, introduced by Senators Schumer, Toomey, Warner, and Subcommittee Ranking Member Crapo, will help restore effective access to the public markets for emerging growth companies without compromising investor protection. Restoring that access will spur U.S. job creation and economic growth at a time when we desperately need both. I appreciate the opportunity to discuss with you the challenges we face and the merits of this important bill.

**Challenges Facing the U.S. IPO Market**

For the last half-century, America's most promising young companies have pursued IPOs to access the additional capital they need to hire new employees, develop their products and expand their businesses nationally and globally. Often the most significant step in a company's development, IPOs have enabled emerging growth companies to generate new jobs for the U.S. economy, while public investors of all types have harnessed that growth to build their portfolios and retirement accounts.

The decision to pursue an IPO is a complex one because alternatives do exist: a company can seek to be acquired or can decide to remain private. The most prevalent outcome today for the CEO of an emerging growth company is to be acquired by a larger company. Yet the IPO remains appealing, although demonstrably less so than it was a decade ago, for a variety of reasons. In a survey the IPO Task Force conducted of more than 100 CEOs of companies considering an IPO in the next 24 months, 84 percent of CEOs cited competitive advantage as the primary motivation for going public, while two thirds of them indicated the need for cash to support future growth. And while 94 percent of CEOs agreed that a strong and accessible small-cap IPO market is critical to maintaining U.S. competitiveness, only 9 percent agreed that the market is currently accessible to them.

The data support that unfortunate conclusion. During the past 15 years, the number of emerging growth companies entering the capital markets through IPOs has plummeted relative to historical norms. From 1990 to 1996, 1,272 U.S. venture-backed companies went public on U.S. exchanges, yet from 2004 to 2010, there were just 324 of those offerings. Those companies that do make it to the public markets are taking almost twice as long to do so. During the most recent decade, acquisitions have become the predominant path forward for most venture-backed companies. This is significant because M&A events do not produce the same job growth as IPOs. In fact, an acquisition often results in job losses in the short term as redundant positions are eliminated by the acquirer. While global trends and macroeconomic circumstances have certainly contributed to this prevalence of acquisitions over IPOs, the trend has transcended economic cycles and has hobbled U.S. job creation.

What is driving this precipitous decline in America's IPO market? A number of analyses, including that of the IPO Task Force, suggest that there is no single event behind it. Rather, a complex series of changes in the regulatory environment and related market practices have driven up costs and uncertainty for emerging growth companies looking to go public, and have constrained the amount of information available to investors about such companies, making them more difficult to understand and invest in. These changes have included the advent of electronic trading, new order-routing rules, Regulation FD, the Gramm-Leach-Bliley Act of 1999, decimalization, the Sarbanes-Oxley Act of 2002, the Global Research Analyst Settlement, and aspects of the Dodd-Frank Act of 2009. Every one of these developments

and each piece of legislation addressed significant issues. Yet, the cumulative effects of these regulations over the years have produced an unintended consequence: They have limited the ability of emerging growth companies to go public.

In effect, these changes have shifted the focus of emerging growth companies away from pursuing IPOs and toward positioning themselves for acquisition by a larger company. In fact, approximately 85 percent of the emerging growth company CEOs surveyed by the IPO Task Force indicated that going public is not as attractive as it was in 1995. This shift toward acquisitions and away from IPOs by emerging growth companies is problematic for the U.S. economy because, as mentioned, acquisitions simply do not generate the same amount of job growth as IPOs. Consider the impact on jobs and the general economy if companies such as FedEx, Intel or Microsoft were acquired by larger corporations instead of going public and maintaining the independent growth that led them to be market leaders in their own right.

Addressing these multiple, interrelated factors and mitigating their effects will require a measured and nuanced response. Many of the new regulations in recent years have addressed specific concerns and delivered valuable protections to investors—protections that any efforts to rebalance the regulatory scales for emerging companies must recognize and respect. These new requirements have raised the bar for companies pursuing IPOs—in terms of size, compliance and cost—in ways that should inspire greater investor confidence in our markets. Similarly, many of the related market evolutions have increased access and lowered costs for some public investors. These factors have resulted in a fundamental restructuring of the U.S. capital markets system over the past 15 years. Our IPO Task Force report examines this restructuring and its implications in greater depth. For my purposes here, I will focus on the regulatory aspects of the current IPO challenge and how S. 1933 can mitigate it.

I believe the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011" provides an opportunity to thoughtfully recalibrate these regulations to reduce barriers for ECG's in three crucial ways. First, it recognizes emerging growth companies as a unique category facing acute challenges in accessing public capital. Second, it provides a limited, temporary and scaled regulatory compliance pathway, which the IPO Task Force referred to as an "on-ramp," that will reduce the costs and uncertainties of accessing public capital. Third, it improves the flow of information to investors about the initial offerings for emerging growth companies. The legislation follows a balanced approach by structuring the on-ramp as a temporary feature available only for a limited period of 1 to 5 years, depending on the size of the company.

**Recognizing "Emerging Growth Company" Challenges**

The "Reopening American Capital Markets to Emerging Growth Companies Act of 2011" would establish a new category of issuer, called an "emerging growth company" (EGC) that has less than $1 billion in annual revenues at the time of SEC registration. These companies would benefit from a temporary regulatory on-ramp designed to provide EGCs with a smooth entryway into the IPO market while ensuring adequate investor protection. This on-ramp status would last only for a limited period of 1 to 5 years, depending on the company's size, and it would encourage EGCs to go public while ensuring that they achieve full compliance as they mature and build the resources necessary to sustain the level of compliance infrastructure associated with larger enterprises.

As noted, EGC status, and the scaled regulation associated with the on-ramp, would last for a limited period of 1 to 5 years. Specifically, EGC status would cease at the first fiscal year-end after the company (1) reaches $1 billion in annual revenue; (2) has been public for 5 years; or (3) becomes a "large accelerated filer" with more than $700 million in public float (*i.e.,* market value of shares held by nonaffiliates). To put the bill's limited scope in perspective, if the on-ramp provisions were in effect today, they would apply to only 14 percent of public companies and only 3 percent of total market capitalization, according to the IPO Task Force estimate. For example, Ford Motor Company would not qualify as an EGC eligible for the on-ramp. Nor would Zynga be expected to qualify. However, Carbonite and Horizon Pharmaceuticals would.

As someone who has spent the last 15 years seeking out, evaluating, investing in, and helping to build promising young companies, I cannot overemphasize the value of a robust and accessible IPO market. In our survey of emerging growth company CEOs, 86 percent of respondents listed accounting and compliance costs as a major concern of going public. Again, over 85 percent of CEOs said that going public was not as attractive of an option as it was in 1995. Given these concerns, for CEOs of successful companies deciding between pursuing an IPO or positioning themselves

for an acquisition, the scaled disclosure and cost flexibility provided by the bill could help make an IPO the more attractive option.

**Reopening Access Through Scaled Regulation**

The bill provides qualifying EGCs with a narrow, temporary and scaled regulatory compliance pathway that would reduce the costs of accessing public capital without compromising investor protection. The bill's transitional relief is limited to those areas of compliance that are significant cost drivers. While those requirements may sensibly apply to larger enterprises, allowing EGCs to phase in these costs would not compromise investor protection for smaller public companies that are following the scaled regulation that the SEC has already developed and approved for smaller reporting companies. In this way, the on-ramp benefits from the SEC's prior regulatory actions that carefully balanced both investor protection and the promotion of efficiency, competition, and capital formation, consistent with Section 3(f) of the Securities Exchange Act of 1934. The scaled regulations under the bill include:

*Section 404(b) of Sarbanes-Oxley.* In addition to the typical cost of auditing their financial statements, large public companies must pay an outside auditor to attest to the company's internal control over financial reporting. Studies have shown that compliance with Sarbanes-Oxley can cost companies more than $2 million per year, with much of that cost associated with the Section 404(b) requirements. All companies with a public float of less than $75 million are already exempt from Section 404(b) because Congress has recognized the substantial burden this requirement would impose on smaller companies. In addition, existing regulations provide that all newly public companies—regardless of their size or maturity—benefit from a transition period of up to 2 years before they are required to comply with Section 404(b) of Sarbanes-Oxley. Under current law, this transitional relief is available even for very large companies that would not qualify as EGCs. Moreover, this existing transitional relief is necessary even though the auditing standard for the Section 404(b) audit is intended to be flexible and scalable. (The Public Company Accounting Oversight Board's Auditing Standard No. 5 expressly permits a top-down, scalable approach for the audit and recognizes that "a smaller, less complex company" may "achieve its control objectives differently than a more complex company.") Building on these concepts, S. 1933 provides EGCs with a limited and targeted extension of the existing transition period during the on-ramp for compliance with Section 404(b). The bill would not affect current requirements under which management is responsible for establishing and maintaining internal control over financial reporting and disclosure controls and procedures.

*Look-back for audited financials.* EGCs would be required to provide audited financial statements for the 2 years prior to registration, rather than 3 years. This 2-year period already applies under existing SEC rules for companies with a public float of less than $75 million. For the year following its IPO, the EGC will go forward reporting 3 years of audited financials, similar to larger issuers, without facing an incremental cost burden because the third year will have already been audited in connection with the IPO. The transition period for this element, therefore, will only extend for a year, which is much shorter than the full on-ramp period.

*Exemptions from long form compensation disclosure.* The EGC will disclose its compensation arrangements using the established format that the SEC has adopted for smaller reporting companies. The bill would also exempt EGCs from the requirement to hold an advisory stockholder vote on executive compensation arrangements, including advisory votes on change-of-control compensation arrangements and the frequency of future advisory votes. The SEC has given smaller reporting companies an additional year to comply with the new rules, in light of the additional burden these requirements impose. The bill would extend this transitional relief for EGCs during the on-ramp period. During that time, EGCs would still be required to comply with all stock exchange governance requirements, including director independence requirements.

The on-ramp period will give EGCs the opportunity to realize the benefits of going public in their first, critical years in the public markets. They will be able to allocate more of the capital they raise from the IPO process toward hiring new employees, developing new products, expanding into new markets and implementing other elements of their growth strategies—as opposed to funding the type of complex compliance apparatus designed for larger, more mature companies. At the same time, EGCs and their management will be able to devote more time, energy and other resources to managing the business, charting the path to future growth and implementing compliance systems that are appropriate for smaller, more nimble companies. Indeed, 92 percent of the public-company respondents in the IPO Task Force's CEO survey identified the burden of administrative reporting as a significant chal-

lenge, while 91 percent noted that reallocating their time from company building to compliance management has been a major challenge.

The IPO Task Force's membership included institutional investors who provided important perspectives that shaped the specific recommendations we made. In particular, the scaled regulation that we ultimately recommended, and which S. 1933 reflects, incorporated key recommendations from the investor community that this constituency believes is consistent with investor protection and will ensure full disclosure of all relevant information by EGCs as well as the availability and flow of information for investors.

**Improving the Availability and Flow of Information for Investors**

Along with compliance burdens, post-IPO liquidity ranked very high among the concerns of emerging growth company CEOs. Institutional investors in particular expressed concerns about the dearth of information and exposure they had to IPO companies versus what they receive for other securities, making it difficult to get enough information to make an informed investing decision about a new issue. In order to increase post-IPO liquidity, investors need efficient markets with abundant, accurate information about newly public companies. In an effort to make IPOs more attractive to EGCs and investors, the bill would improve the flow of information about EGCs to investors before and after an IPO. It will do so primarily by updating existing regulations to account for advances in modes of communication since the enactment, 78 years ago, of the Securities Act of 1933, and to recognize changes in the information available to investors in the Internet era. Current rules relating to analyst research were initially adopted more than 40 years ago—long before the fundamental changes that the Internet has brought regarding the availability of information, including instantaneous access to registration statements filed with the SEC. The SEC has amended these rules only modestly and incrementally since that time. Specifically, the bill will:

*Close the information gap for emerging growth companies.* Existing rules allow investment banks participating in the underwriting process to publish research on large companies on a continuous basis, but prohibit those investment banks from publishing research on EGCs. This bill would allow investors to have access to research reports about EGCs concurrently with their IPOs. In other words, S. 1933 extends to EGC investors the research coverage currently enjoyed by investors in very large companies. At the same time, the bill preserves the extensive investor protections adopted in this area within recent years. For example, S. 1933 leaves intact robust protections such as:

- Sarbanes-Oxley Section 501, which requires analysts and broker-dealers that publish research reports to disclose any potential conflicts of interest that may arise when they recommend an issuer's equity securities, including whether an analyst or broker-dealer currently owns other debt or equity investments in the issuer or has received compensation from the issuer for publishing the report or whether the issuer is a client of the broker-dealer.
- SEC Regulation AC, which requires broker-dealers to include in all research reports a statement by the research analyst certifying that the views expressed in the research report accurately reflect the research analyst's personal views about the securities and to disclose whether the research analyst was compensated in connection with the specific recommendations.
- The Global Research Analyst Settlement of 2003, which severed the link between research and investment banking activities at large investment banks, required investment banks to use independent research and made analysts' historical ratings and price targets publicly available.

As the SEC recognized in 2005, the "value of research reports in continuing to provide the market and investors with information about reporting issuers cannot be disputed." We agree that research reports are indisputably valuable to investors and endorse the changes in S. 1933 that would permit research coverage of EGCs at the time of an IPO, rather than the current regime, which permits research only for large, established public companies. The bill's changes would address the current information shortfall by providing a way for investors to obtain research about IPO candidates, while leaving unchanged the robust and extensive investor protections that exist to ensure the integrity of analyst research reports.

*Permit emerging growth companies to "test the waters" prior to filing a registration statement.* The bill would permit EGCs to gauge preliminary interest in a potential offering by expanding the range of permissible prefiling communications to institutional and qualified investors. This would provide a critically important mechanism for EGCs to determine the likelihood of a successful IPO. For a company on the verge of going public, but not quite ready, getting that investor feedback beforehand

improves the chances of a successful IPO at a later date. This benefits issuers and the public markets in the process by helping otherwise-promising companies avoid a premature offering. All of the antifraud provisions of the securities laws would still apply to these communications, and the bill ensures that the delivery of a statutory prospectus would still be required prior to any sale of securities in the IPO.

*Permit confidential prefiling with the SEC.* Currently, foreign entities are permitted to submit registration statements to the SEC on a confidential basis under certain circumstances, even though U.S. companies are not. Since the recent introduction of S. 1933, the SEC staff has updated its policy in this area to permit confidential filings for foreign Governments registering debt securities and foreign private issuers that are listed or are concurrently listing on a non-U.S. securities exchange. This accommodation is not available to domestic issuers. Allowing U.S. companies to make confidential submissions of draft registration statements would allow EGCs to commence the SEC review process in a far more efficient and effective manner. In particular, this process would remove a significant inhibitor to IPO filings by allowing pre-IPO companies to begin the SEC review process without publicly revealing to competitors sensitive commercial and financial information before those pre-IPO companies are able to make an informed decision about the feasibility of an IPO. The bill would require U.S. companies that elect to use the confidential submission process to make public the filing of the initial confidential submission as well as all amendments resulting from the SEC review process, thereby providing full access to the information before an IPO that is traditionally disclosed to the public during the registration process. The bill would also require such a public filing at least 21 days before the pre-IPO company commences a road show with potential investors, providing ample time for public review of all changes made in all amendments to the registration statement occurring during the SEC review process.

**Conclusion**

With the U.S. economic recovery stalled, unemployment hovering near 9 percent and global competition ramping up, the time to revive the U.S. IPO market and jumpstart job creation is now. We believe that the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011" can help us accomplish those goals without compromising important investor protections, including many of the reforms implemented in recent years.

The bill provides measured and limited relief, for a period of 1 to 5 years, to a small population of strategically important companies with disproportionately positive effects on job growth and innovation. We believe that these changes could provide powerful incentives for those emerging companies to more seriously consider an IPO as a feasible alternative when they are deciding between the growth potential of an IPO versus the safer and easier path of an acquisition transaction. As a result, we believe these changes could bring those alternatives back to their historical balance—a balance that has, in prior years, allowed IPOs to occur more easily and, in so doing, supported America's global economic primacy for decades.

I urge the Members of this Committee to support the passage of the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011." By doing so, we can reenergize U.S. job creation and economic growth by helping reconnect emerging companies with public capital—all while enabling the broadest range of investors to participate in the growth of those companies through a healthy and globally respected U.S. capital markets system. These outcomes are not only consistent with the spirit and intent of the current regulatory regime, but also essential to preserving America's strength for decades to come.

In closing, I want to personally thank you for the opportunity to discuss these important issues with you today. I look forward to answering any questions you may have and, I thank you for your service to our country in your capacity as Members of Congress and your attention to this critical issue.

# Rebuilding the IPO On-Ramp

*Putting Emerging Companies and*

*the Job Market Back on the Road to Growth*

Issued by the IPO Task Force
October 20, 2011

Presented to The U.S. Department of the Treasury

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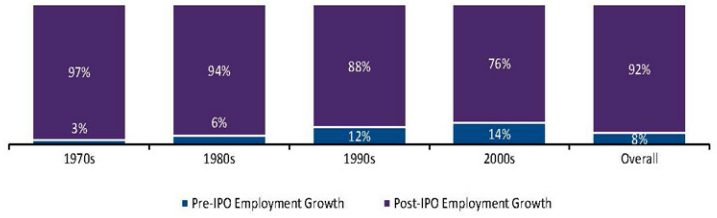
## I. Executive Summary

This report recommends specific measures that policymakers can use to increase U.S. job creation and drive overall economic growth by improving access to the public markets for emerging, high-growth companies.

For most of the last century, America's most promising young companies have pursued initial public offerings (IPOs) to access the additional capital they need to hire new employees, develop their products and expand their businesses globally. Often the most significant step in a company's development, IPOs have enabled these innovative, high-growth companies to generate new jobs and revenue for the U.S. economy, while investors of all types have harnessed that growth to build their portfolios and retirement accounts. We refer to these companies in this report as "emerging growth" companies (defined more specifically for purposes of this report on page 20).

**Chart A: IPOs Finance Significant Job Creation**




*Source: Venture Impact 2007, 2008, 2009, & 2010 by IHS Global Insight; IPO Task Force August 2011 CEO Survey.*

During the past 15 years, the number of emerging growth companies entering the capital markets through IPOs has plummeted relative to historical norms. This trend has transcended economic cycles during that period and has hobbled U.S. job creation. In fact, by one estimate, the decline of the U.S. IPO market had cost America as many as 22 million jobs through 2009.[1] During this same period, competition from foreign capital markets has intensified. This dearth of emerging growth IPOs and the diversion of global capital away from the U.S. markets – once the international destination of choice – have stagnated American job growth and threaten to undermine U.S. economic primacy for decades to come.

In response to growing concerns, the U.S. Treasury Department in March 2011 convened the Access to Capital Conference to gather insights from capital markets participants and solicit recommendations for how to restore access to capital for emerging companies – especially public capital through the IPO market. Arising from one of the conference's working group conversations, a small group of professionals representing the entire ecosystem of emerging growth companies – venture capitalists, experienced CEOs, public investors, securities lawyers, academicians and investment bankers – decided to form the IPO Task Force to examine the conditions leading to the IPO crisis and to provide recommendations for restoring effective access to the public markets for emerging, high-growth companies.

In summary, the IPO Task Force has concluded that the cumulative effect of a sequence of regulatory actions, rather than one single event, lies at the heart of the crisis. While mostly aimed at protecting investors from behaviors and risks presented by the largest companies, these regulations and related market practices have:

1. driven up costs for emerging growth companies looking to go public, thus reducing the supply of such companies,

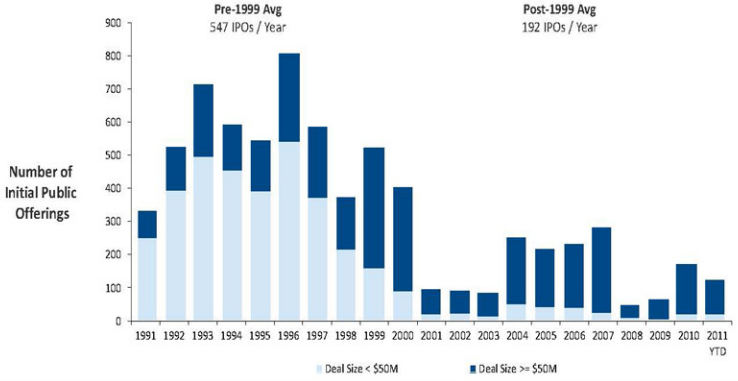
(1) *D. Weild and E. Kim, Grant Thornton, A Wake-up Call for America at page 2 (November 2009).*

2. constrained the amount of information available to investors about such companies, thus making emerging growth stocks more difficult to understand and invest in, and

3. shifted the economics of the trading of public shares of stock away from long-term investing in emerging growth companies and toward high-frequency trading of large-cap stocks, thus making the IPO process less attractive to, and more difficult for, emerging growth companies.

These outcomes contradict the spirit and intent of more than 75 years of U.S. securities regulation, which originally sought to provide investor protection through increased information and market transparency, and to encourage broad investor participation through fair and equal access to the public markets.

**Chart B: IPOs are Down…Particularly Smaller IPOs**




*Sources: JMP Securities, Dealogic, Capital Markets Advisory Partners, Grant Thornton*

To help clear these obstacles for emerging growth companies, the IPO Task Force has developed four specific and actionable recommendations for policymakers and members of the emerging growth company ecosystem to foster U.S. job creation by restoring effective access to capital for emerging growth companies. Developed to be targeted, scalable and in some cases temporary, these recommendations aim to bring the existing regulatory structure in line with current market realities while remaining consistent with investor protection. The task force's recommendations for policymakers are:

1. **Provide an "On-Ramp" for emerging growth companies using existing principles of scaled regulation.** We recommend that companies with total annual gross revenue of less than $1 billion at IPO registration and that are not recognized by the SEC as "well-known seasoned issuers" be given up to five years from the date of their IPOs to scale up to compliance. Doing so would reduce costs for companies while still adhering to the first principle of investor protection. (Page 19)

2. **Improve the availability and flow of information for investors before and after an IPO.** We recommend improving the flow of information to investors about emerging growth companies before and after an IPO by increasing the availability of company information and research in a manner that accounts for technological and communications advances that have occurred in recent decades. Doing so would increase visibility for emerging growth companies while maintaining existing regulatory restrictions appropriately designed to curb past abuses. (Page 26)

3. **Lower the capital gains tax rate for investors who purchase shares in an IPO and hold these shares for a minimum of two years.** A lower rate would encourage long-term investors to step up and commit to an

allocation of shares at the IPO versus waiting to see if the company goes public and how it trades after its IPO. (Page 30)

In addition to its recommendations for policymakers, the task force has also developed a recommendation for members of the emerging growth company ecosystem:

4. **Educate issuers about how to succeed in the new capital markets environment.** The task force recommends improved education and involvement for management and board members in the choice of investment banking syndicate and the allocation of its shares to appropriate long-term investors in its stock. Doing so will help emerging growth companies become better consumers of investment banking services, as well as reconnect buyers and sellers of emerging company stocks more efficiently in an ecosystem that is now dominated by the high-frequency trading of large cap stocks. (Page 31)

The recommendations above aim to adjust the scale of current regulations without changing their spirit. Furthermore, the task force believes that taking these reasonable and measured steps would reconnect emerging companies with public capital and re-energize U.S. job creation and economic growth – all while enabling the broadest range of investors to participate in that growth. The time to take these steps is now, as the opportunity to do so before ceding ground to our global competitors is slipping away.

For this reason, the members of the IPO Task Force pledge their continued participation and support of this effort to put emerging growth companies, investors and the U.S. job market back on the path to growth.

## II. Brief Background and Purpose

In March 2011, the U.S. Department of the Treasury convened the Access to Capital Conference to gather insights from capital markets participants and solicit recommendations for how to restore effective access to capital for emerging companies, including public capital through the IPO market. Arising from of one of the conference's working group conversations, a small group of professionals representing the entire ecosystem of emerging growth companies – venture capitalists, experienced CEOs, public investors, securities lawyers, academicians and investment bankers – decided to form the IPO Task Force (Appendix A, page 33) in order to 1) examine the challenges that emerging growth companies face in pursuing an IPO and 2) develop recommendations for helping such companies access the additional capital they need to generate jobs and growth for the U.S. economy and to expand their businesses globally.

This report recommends specific measures that policymakers can use to increase U.S. job creation and drive overall economic growth by improving access to the public markets for emerging, high-growth companies.

## III. Emerging Growth Companies Drive U.S. Job Creation

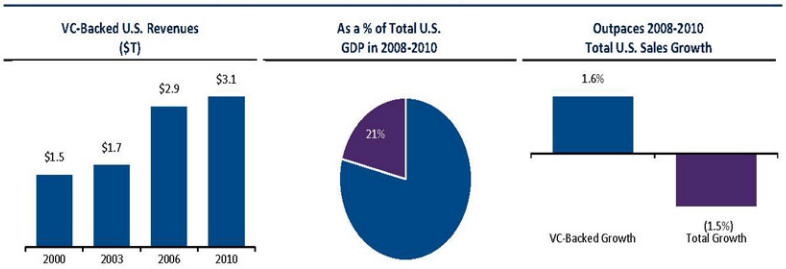
For most of the last century, America's most promising young companies have pursued IPOs to access the additional capital they need to hire new employees, develop their products and expand their businesses globally. Often the most significant step in a company's development, IPOs enabled these innovative, high-growth companies to generate new jobs and revenue for the U.S. economy, while investors of all types harnessed that growth to build their portfolios and retirement accounts. We refer to these companies in this report as "emerging growth" companies (defined more specifically for purposes of this report on page 20).

***92% of job growth occurs after a company's IPO. Most of that growth occurs within the first five years of the IPO.[2]***

The role of these emerging growth companies in creating American jobs cannot be understated. From 1980 to 2005, firms less than five years old accounted for all net job growth in the U.S.[1] In fact, 92 percent of job growth occurs after a company's initial public offering, according to data from IHS Global Insight. Furthermore, in a survey of emerging growth companies that have entered the public markets since 2006, respondents reported an average of 86 percent job growth since their IPOs (See Appendix C, page 36).

Indeed, some of America's most iconic and innovative companies – Apple, Cisco, FedEx, Genentech and Starbucks – entered the public markets through small-cap offerings at a time when the markets were more hospitable to small- and mid-cap stocks. These companies also received venture capital funding as startups. While none of the challenges or recommendations outlined in this report are exclusive to venture capital-backed companies, such companies serve as useful proxies when discussing the disproportionately positive impact of emerging growth companies on U.S. job creation and revenue growth. For example, while investment in venture-backed companies equates only to between 0.1 percent and 0.2 percent of U.S. gross domestic product each year, companies with venture roots employed 11 percent of the total U.S. private sector workforce and generated revenues equal to 21 percent of U.S. GDP in 2010.[3]

**Chart C: Innovative Companies Create Jobs and Grow Quickly**




*Source: Venture Impact 2007, 2008, 2009 & 2010 by IHS Global Insight.*

(1) *Source: Venture Impact Study 2010 by IHS Global Insight*

(2) *Source: Ibid.*

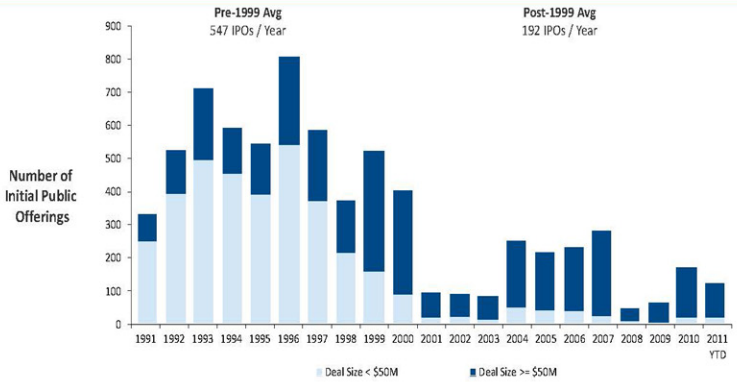
(3) *Source: Ibid.*

## IV. The IPO Market Decline

Over the last decade, the number of emerging growth companies entering the capital markets through IPOs has plummeted. This trend has persisted independent of the economic cycles during this same time. After achieving a one-year high of 791 IPOs in 1996, the U.S. averaged fewer than 157 per year from 2001 to 2008. In fact, only 45 companies went public in 2008.[1] The numbers for the last two years have rebounded slightly, but remain well below historical norms and well below the amount required to replace the number of listed companies lost to mergers, acquisitions, de-listings and bankruptcy.

Venture-backed emerging growth companies illustrate the trend. From 1991 to 2000, nearly 2,000 such companies (which, as noted above, typically grow larger and faster than their peers) went public as compared to only 477 from 2001 to 2010.[2] That represents a drop of more than 75 percent. In addition, the companies that make it to the public markets are taking twice as long to do so: The median age of a venture-backed company at the time of its IPO has nearly doubled in recent years. The average age at IPO of companies going public between 1997 and 2001 was approximately five and a half years, compared with more than nine years for companies going public between 2006 and 2011.[3] As a result, many smaller companies have life spans as private companies longer than venture fund life cycles and employee stock option terms.

**Chart D: IPOs are Down…Particularly Smaller IPOs**




*Sources: JMP Securities, Dealogic, Capital Markets Advisory Partners, Grant Thornton*

Over this same period, the prevalence of IPOs versus acquisitions of emerging growth companies has undergone a stunning reversal. Acquisitions by a shrinking number of larger companies (due to the lack of IPOs) have become the primary liquidity vehicle for venture capital-backed companies as compared to IPOs.[4] This is significant because M&A events don't produce the same job growth as IPOs – nor do they allow investors to participate as directly in the economic growth of a stand-alone company. In fact, M&A events result in job losses in the short term as the acquiring company looks to eliminate redundant positions between the two enterprises. Subsequent job growth may occur at the acquiring company, but only over time, and only after those initial job losses are recovered.

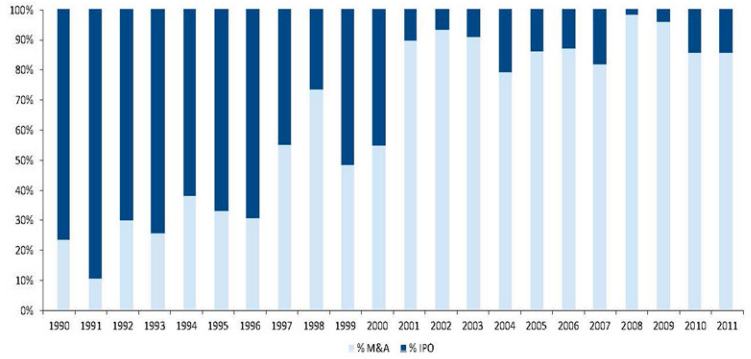
(1) *Source: JMP Securities, Dealogic.*

(2) *Source: Thomson Reuters, National Venture Capital Association.*

(3) *Source: Ibid.*

(4) *Source: VentureOne data.*

**Chart E: Shift from IPOs to M&A**




*Source: Thomson Reuters/National Venture Capital Association (Based on number of exits per year; M&A exits are for private company sales only).*

## V. Fewer IPOs: Less Job Growth

***Imagine how different Seattle, Cupertino or Austin would look today if — instead of going public — Microsoft, Apple or Dell had undergone an acquisition by an old-line conglomerate.***

Given the propensity of emerging growth companies for generating new jobs, it is little wonder that the primary casualty in the decline of America's IPO market has been job creation. By one count, "up to 22 million jobs may have been lost because of our broken IPO market."[1] Meanwhile, U.S. Labor Department statistics suggest that the number of unemployed and under-employed Americans reached approximately 25 million in 2011.[2]

The adverse effects brought on by the IPO market decline across the entire American capital markets system have begun to undermine U.S. global economic primacy. The United States raised just 15 percent of global IPO proceeds in 2010, down from its average of 28 percent over the preceding 10 years.[3]

***The losers in the IPO crisis are the U.S. workers who would have been hired by emerging growth companies had they been able to go public and generate new jobs through their subsequent growth.***

*(1) D. Weild and E. Kim, Grant Thornton, A Wake-up Call for America at page 2 (November 2009).*

*(2) U.S. Department of Labor, "The Employment Situation – May 2011" News Release.*

*(3) Dent, Mary J. "A Rose by Any Other Name: How Labels Get In the Way of U.S. Innovation Policy" March 2011; U.S. Global IPO Trends, supra note 42.*

## VI. Regulatory and Market Roadblocks

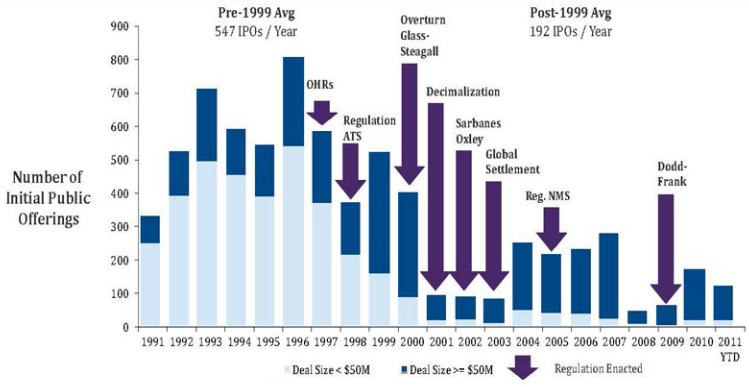
While the costs of the IPO market's decline to the U.S. economy are clear, its causes cannot be traced to one single event. Rather, a complex series of changes in the regulatory environment and related market practices, most of which were intended to solve problems unrelated to emerging growth company IPOs, has:

1. driven up costs for emerging growth companies looking to go public, thus reducing the supply of such companies,
2. constrained the amount of information available to investors about such companies, thus making emerging growth company stocks more difficult to understand and invest in, and
3. shifted the economics of investment banking away from long-term investing in such companies and toward high-frequency trading of large-cap stocks, thus making the IPO process less attractive to, and more difficult for, emerging growth companies.

These outcomes contradict the spirit and intent of more than 75 years of U.S. securities regulation, which originally sought to provide investor protection through increased information and market transparency, and to encourage broad investor participation through fair and equal access to the public markets. In most cases, the regulations were intended to address market issues created exclusively by the behavior of, and risks presented by, the largest companies. While some regulations succeeded in this aim, almost all of them have created unintended adverse effects on emerging growth companies looking to access public capital.

The collective result of these well-intentioned but "one-size-fits-all" regulations and the market changes they have engendered amounts to nothing less than a fundamental change in the structure of the U.S. capital markets. The losers in this restructuring are the U.S. workers who would have been hired by emerging growth companies had those companies been able to go public and generate new jobs through their subsequent growth.

**Chart F: IPOs and Regulatory/Market Changes**




*Sources: JMP Securities, Dealogic, Capital Markets Advisory Partners, Grant Thornton.*

## A. Impact on Supply of Emerging IPOs

***While 96% of emerging growth companies surveyed agreed that a strong and accessible small cap IPO market was important, only 13% agreed that the current market is easily accessible for small companies.*** [1]

An IPO represents one of the most significant steps in a young company's growth cycle. Unfortunately, a series of rules, regulations and other compliance issues aimed at large-cap, already-public companies has increased the time and costs required for emerging companies to take this critical first step.

Many of the rules and regulations adopted over the last 15 years aimed to respond to scandals or crises at major public companies and to restore confidence in the public markets by requiring public companies to adopt more stringent financial and accounting controls. These requirements are included in the dozens of rulemakings (some of which are still pending) following the Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and various accounting and compliance requirements. Financial Accounting Standards Board (FASB) and Public Company Accounting Oversight Board (PCAOB) rules can further increase the compliance challenge, as discussed further below.

**Chart G: The Regulatory Cascade**

| 1996-Today | Accounting & Compliance from Policymakers & Industry |
|---|---|
| 1996 | Advent of Electronic Trading |
| 1999 | Gramm-Leach-Bliley Overturns Separation Of Commercial & Investment Banking |
| 2001 | Decimalization Introduced for All Exchange Traded Shares |
| 2002 | Sarbanes-Oxley Act |
| 2002-Today | Additional Accounting & Compliance from Policymakers & Industry |
| 2003 | Global Analyst Settlement Separates Research & Banking |
| 2009-Today | Dodd-Frank Act |

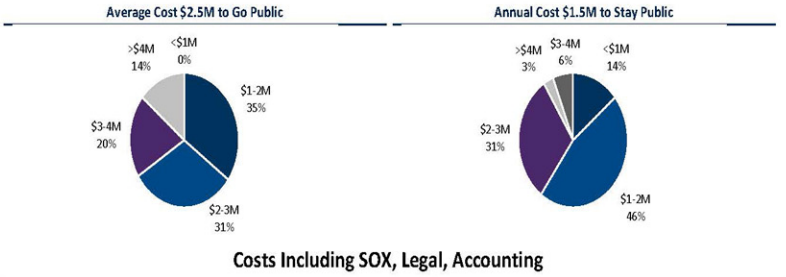
Two recent surveys of pre- and post-IPO companies – one initiated by the IPO Task Force (see Appendix C for summary results) and one conducted by a company currently in registration by reviewing public filings of its peers[2] – place the average cost of achieving initial regulatory compliance for an IPO at $2.5 million, followed by an ongoing compliance cost, once public, of $1.5 million[3] per year. These figures can represent a significant amount of an emerging company's earnings before interest, taxes, depreciation and amortization (EBITDA) and can lower the company's market cap based on EBITDA multiples by tens of millions of dollars. Respondents to the task force survey listed the regulatory burdens of going public as their primary concerns.

(1) *IPO Task Force August 2011 CEO Survey (see Appendix C).*

(2) *Survey conducted by a private company via an independent review of public filings for 47 IPOs raising less than $200M in 2011.*

(3) *Results compiled from two different surveys. The first was initiated by the Task Force; methodology and summary results can be found in Appendix C. Survey conducted by a private company via an independent review of public filings for 47 IPOs raising less than $200M in 2011.*

**Chart H: The Costs of Going and Staying Public are High**




*Source: IPO Task Force August 2011 CEO Survey of incremental IPO costs. Sample set of 35 CEOs of companies that went public since 2006. Consistent With Independent Review of Public Filings for 47 2011 IPO's Raising Less Than $200M (Avg. Cost of $3M for IPO).*

These high costs can force a grim tradeoff for management: 1) commit these resources to achieving and maintaining compliance in an uncertain IPO market, or 2) postpone (or forgo altogether) an IPO to continue developing the company's product offering and building the enterprise at a lower growth trajectory. Given that completing an IPO involves a great deal of risk and uncertainty for an emerging growth company, especially in a down cycle, many companies are choosing the second option with the target exit being acquisition by a larger company. As described earlier, this outcome not only generates less short-term job growth, but can actually reduce the number of jobs in the short run when the acquiring company eliminates redundant positions.

While these rules apply to public companies, emerging growth companies must be ready to comply with them at, or very soon after, the time of their IPOs and typically must begin to build up a significant compliance infrastructure a year or two ahead of time. Currently, companies with market capitalizations of under $75 million (known as "Smaller Reporting Companies" or "SRCs") are exempted from a broad range of rules that apply to all larger companies. While the idea behind this exemption is sound, the execution falls short of market realities. First, it creates a false dichotomy within the equities space wherein a company is either a micro-cap or a large cap. This is akin to classifying all motor vehicles as either sub-compact cars or semi-trucks – with nothing in between. Second, the current system holds even the smallest cap companies to the large-cap standards before they can go public. As a result, emerging growth companies and U.S. workers pay the price – literally.

The continued implementation of various rules under the Dodd-Frank Act, along with proposed FASB and PCOAB initiatives under discussion, will likely further increase the compliance challenge for emerging growth companies. For example, matters under consideration in the PCOAB's recent concept release on new auditor firm rotation threaten to increase costs even further for emerging growth companies. This requirement is in addition to the existing requirement that all individual auditors assigned to an account be rotated regularly with other auditors within the same firm. For an emerging company, hiring a new audit firm a year or two after an IPO is very expensive. This is because it often takes a company a year or two to fully educate its auditor about the company's business model and for the auditor to use that knowledge to deliver services efficiently. For these reasons, the first year or two of the engagement are the most costly for a company. The rotation rule would force a company to drop its audit firm just as the relationship is becoming cost-efficient, and start the education process anew with a different audit firm. Relief under current and proposed rules for small companies does not compromise investor protection as the incidence of accounting fraud by small companies is no greater than for their large peers.[1]

*(1) 10-Year Study by Audit Analytics Released May 2011.*

Cumulatively, the unintended effects of these current and pending regulations – the increasing length of time between initial start-up and liquidity event, the increasing compliance costs associated with becoming and maintaining a public company in the U.S., the significantly larger market capitalization and revenue size required to go public, the financial, accounting and compliance infrastructure required to go public in today's environment – have likely delayed, diverted or discouraged hundreds of companies from entering the public markets since the mid-1990s. The long-term economic impact for U.S. workers and consumers resulting from the lost jobs and revenues from these companies cannot be underestimated.

**Recommendation #1:**

**Provide an "On-Ramp" for emerging growth companies using existing principles of scaled regulation.**

**1.1** Create a new category of issuer, "emerging growth company," that lasts up to five years and is transitional.

**1.2** Define such companies by the following criteria:

- **1.2.1** Annual revenue of less than $1 billion
- **1.2.2** Not recognized by the SEC as a "well-known seasoned issuer"
- **1.2.3** Registered for an IPO, or less than five years post-IPO

**1.3** Build on existing scaled disclosure rules to ease compliance burdens during the transition period while maintaining investor protection.

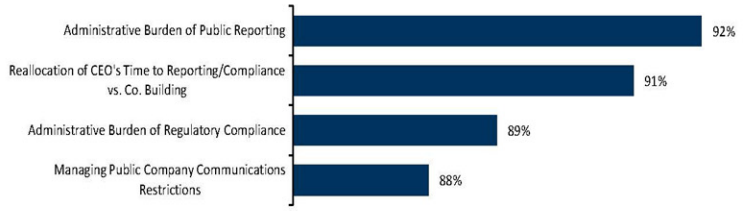
**1.4** Apply scaled On-Ramp regulations only as long as a company qualifies as an emerging growth company.

**Detailed recommendation on page 19.**

The task force made its recommendations with the objective of maintaining the principles of investor protection and sought investor input into the limited measures that are recommended in this report. When analyzing the cohorts of emerging growth companies that went public over the last five years, emerging growth companies never exceed 15 percent of all companies listed on the exchange (see Appendix D, page 42). Market cap was rejected as a basis for determining status as an emerging growth company because, in a volatile market, companies often have limited visibility of or control over their market cap. A revenue-based test satisfied the objective of increased certainty regarding the applicability of key regulations.

The primary reasons emerging growth companies seek capital are to grow their businesses, pursue promising new products and innovations, and create jobs. Enabling them to use an On-Ramp (for some or all of the scaled regulation and disclosure) for a period of time after their IPOs will reduce their costs in trying to achieve these goals. Based on interviews with pre- and post-IPO companies, we would expect the On-Ramp scaling to reduce internal and external compliance costs for such companies by 30 percent to 50 percent. It will also allow them to build the resources to satisfy the additional regulatory burdens to which large, mature companies are accustomed. We expect that this will result in a larger supply of emerging growth companies going public and increased job creation over the long term.

**Chart I: Public Company CEOs: Most Significant IPO Challenges**




*Source: IPO Task Force August 2011 CEO Survey.*

***Per a 10-year study by Audit Analytics released in May 2011, the incidence of restatement by small companies is no different from their larger peers and is proportional to their percentage of the public company population.***

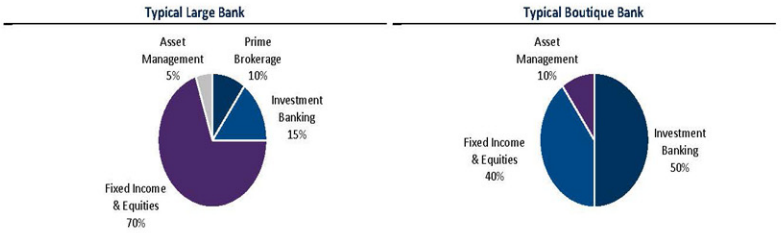
## B. Changes to the IPO Channel

As described earlier, the extraordinary sequence of regulatory interventions and the market changes it has engendered have fundamentally changed the structure of the U.S. capital markets. This new market structure has shifted the economic incentives for financial institutions away from long-term investing in a company's fundamental growth – upon which emerging growth companies and their IPOs rely – and toward short-term trading driven by volatility and changes in market price. In the process, it has broken the traditional relationship between buyers and sellers of emerging growth company stocks.

This shift began in the late 1990s with the rise of electronic trading, which led to lower commissions and reduced the role of traditional brokers, who helped to expose investors to a wide array of stocks – including small caps. The adoption of decimal pricing (wherein stocks are priced in pennies instead of by fractions of dollars) by 2001 further reduced the economic opportunity per trade for investment banks.

In the new, low-cost, frictionless environment promulgated by electronic trading and decimalization, investment banks now generate revenue primarily by executing a high volume of low-priced trades meant to capitalize on short-term changes in the price of highly liquid, very large-cap stocks.

**Chart J: Channel Focus: Trading Drives Revenue for Largest Investment Banks**




*Source: JMP Securities.*

The rise of algorithmic trading strategies and high-frequency execution (known collectively as high-frequency trading, or HFT) illustrates this shift in stark terms. High-frequency trading now accounts for nearly 75 percent of all equities trading volume at U.S. exchanges,[1] compared with slightly more than 20 percent in 2004.[2]

The problem for emerging growth company stocks is that high-frequency trading is driven by non-fundamental factors such as price discrepancies among various market makers, relationships between various stocks and commodities, and price movements, as opposed to by a particular company's prospects for growth and profitability. In addition, HFT positions are closed out at the end of every day – the exact opposite of the type of long-term, fundamentals-based strategy that favors emerging growth IPOs. In this environment, large stocks can sometimes function more like commodities whose value is driven more by their volatility, liquidity and the amount of the company's shares available for trading in the public market (its "float") than by the long-term growth they may offer to their holders. With their large floats and high visibility with investors, large-cap stocks can support this model. Most investment banking research, especially for the investment banking firms with significant trading and prime brokerage operations, is now focused on supporting these large cap companies, which represent most of the business of those firms.

(1) *Source: The Tabb Group, Aite Group.*

(2) *Source: The Tabb Group.*

By contrast, emerging growth stocks do not fit this model. They begin their "public" lives with modest liquidity levels and small floats – both of which they must grow over time through strong fundamental growth and increased visibility. Due to this relative lack of liquidity and float, emerging growth company stocks simply don't produce enough trading volume to make money for the investment bank's trading desk and therefore the investment bank as a whole. This undermines the incentive for investment banks to underwrite and make markets for newly public companies.

As the revenue drivers for investment banks have shifted to trading, the focus of their research departments has understandably followed suit. Already, decimalization had put the economic sustainability of sell-side research departments under stress by reducing the spreads and trading commissions that formerly helped to fund research analyst coverage. The Global Analyst Settlement of 2003 increased that stress by prohibiting the direct compensation of research analysts through investment banking revenue. This limited the compensation sources for analysts to trading revenues. As a result, most sell-side research analysts have shifted their attention to the high-volume, high-liquidity large-cap stocks that now drive revenues for their institutions and provide the basis for their compensation. This shift has resulted in less research coverage of emerging growth companies and thus less transparency and visibility into emerging growth companies for investors – an outcome that contradicts the original intent of the regulations in question. Instead, these regulations and market changes have produced less efficient markets in which long-term growth investors have less information about and access to the emerging growth companies that need capital the most.

**Recommendation #2:**

**Improve the availability and flow of information for investors before and after an IPO.**

**2.1** **Improve the availability and flow of research coverage.**

**2.2** **Expand and clarify existing safe harbors.**

**2.3** **Eliminate unnecessary research quiet periods.**

**2.4** **Eliminate unnecessary restrictions on analyst communication.**

**2.5** **Facilitate capital formation by expanding permissible communications between issuers and prospective investors and by providing for confidential IPO filings.**

**Detailed recommendation on page 26.**

The task force developed the above recommendations under the premise that more information for investors is always better than less. It also allows emerging growth companies to "be heard" in the midst of the high-volume, large-cap-dominated trading landscape. Again, this remains consistent with historical first principles regarding the intent of U.S. securities regulation. Improving the flow of information about emerging growth companies to investors before and after an IPO can increase visibility for emerging growth companies while maintaining transparency for investors. In some cases, this will simply require an update of regulations that have been in place for 80 years to reflect today's marketplace and communications realities.

Despite the shift in economics and the paucity of information about emerging growth companies, there remains a vibrant community of boutique investment banks and growth-company investors willing to execute and invest in emerging growth IPOs. In the current environment, however, gaining access to emerging growth IPOs has become a challenge. In the wave of investment bank consolidation triggered by the passage of the Gramm-Leach-Bliley Act of 1999, large institutions acquired many of the most prominent and successful "growth stock investment banks," which increased the market strength of the largest investment banks. The combination of brand power and adverse market cycles has enabled the larger investment banks to garner a dominant market share of the dwindling IPO market. As a result, companies have shifted away from diversified investment banking syndicates that include

growth-oriented investment banking firms who, in the past, were allocated shares to place with investors looking for long-term growth. Instead, current practices favor syndicates that are dominated purely by the largest investment banks. In this model, the large investment banks have incentives to place IPO shares with their biggest trading counterparts, rather than long-term growth investors, who are the strongest holders of emerging growth company IPOs.

Once again, these changes have undermined their original intents by making it more difficult for public investors wishing to invest in the long-term growth of innovative, emerging companies to gain access to such stocks.

**Recommendation #4**

**Members of the emerging growth ecosystem must educate issuers about how to succeed in the new capital markets environment.**

**4.1** **Choice of balanced investment banking syndicate.**

**4.2** **Increase issuer's role in IPO allocation process with the goal to create an optimal mix of investors for the company.**

**4.3** **Improve practice of investor communication.**

**Detailed recommendations on page 31.**

The IPO Task Force developed the above recommendations with the goal of restoring the broken link between emerging growth companies and the public investors who wish to invest in them. By educating issuers about the new capital markets environment described above, we can help them become better consumers of investment banking services and find long-term institutional small-cap investors that best fit their evolving investor bases. This will help reconnect buyers and sellers of emerging growth stocks more efficiently. The Task Force believes responsibility for this education effort lies not with policymakers but rather with all members of the emerging growth company ecosystem.

### C. Impact on Demand

As described in the prior section, demand for emerging growth company IPOs persists among a number of investor communities. This persistent demand in the face of shifting market economics underscores the value that smaller IPOs can still deliver to investors and the urgency of addressing the supply and channel issues outlined earlier in this report. Unfortunately, changes in the U.S. market structure have lowered the supply of such IPOs and have limited both the amount of available information and access to the shares of emerging growth companies for long-term growth investors.

In addition to addressing these measures, policymakers can reinforce demand for emerging growth company IPOs and maximize their effectiveness by using the tax code to create an additional incentive for investors. Such an incentive can draw long-term investors to buy at an emerging growth company's IPO, when that purchase will deliver the greatest benefit for the issuer, which is to bring them into the realm of being a publicly traded company and raise capital for growth. Without these first purchasers, an IPO cannot happen.

**Recommendation #3:**

**Lower the capital gains tax rate for investors who purchase shares in IPO and hold these shares for a minimum of two years.**

**Detailed recommendation on Page 30.**

Using tax policy to encourage long-term investing is a time-tested tool in U.S. regulatory practice. By lowering the capital gains rate for buyers of newly issued stock if they hold it for two years from the IPO date, policymakers can assist emerging growth companies in attracting long-term investors to their IPOs at the initial allocation – thereby helping to ensure that the companies successfully access the public markets and bring the benefits of job growth and appreciation in value to employees and investors alike.

**Chart K: Demand Exists: Emerging Company IPOs Deliver Returns to Investors**

| Post IPO Market Cap | | 1 Day | 1 Month | 3 Months | 6 Months | 1 Year |
|---|---|---|---|---|---|---|
| $200M-$500M | Average | 27.5% | 34.8% | 45.1% | 43.9% | 33.5% |
| $1B or more | Average | 35.9% | 39.7% | 37.7% | 32.8% | 28.5% |

*Source: JMP Securities, Dealogic.*
*Note: Includes all IPOs from 1/1/2011-9/30/2011.*

## VII. Detailed Recommendations

The precipitous decline of the U.S. IPO market – driven by a paucity of emerging growth companies going public – has stifled job creation, undermined U.S. economic strength and imperiled America's global technology leadership. Historically one of the most reliable routes to growth for young companies, the small cap IPO market has been damaged and needs immediate repair.

This decline stems from a fundamental shift in the structure of the U.S. capital markets brought on primarily by regulations and related market forces. For some aspects of the new market reality, such as decimalization, there's no turning back – nor should there be, as investors have benefited from greater market access and reduced trading costs. For a number of other factors, however, opportunities exist to make limited and reasonable adjustments that can help restore the access to the public capital that emerging growth companies need to hire new employees, develop their products and grow their businesses globally.

To this end, the IPO Task Force has developed four recommendations that can serve as a roadmap for policymakers and members of the emerging growth company ecosystem to revive America's IPO market and the jobs growth it can generate. Developed to be targeted, scalable and in some cases temporary, these recommendations aim to bring the existing regulatory structure in line with current market realities while remaining consistent with its overarching goals of increased investor protection and participation. The task force's recommendations for policymakers are:

1. **Provide an "On-Ramp" for emerging growth companies using existing principles of scaled regulation.** We recommend that companies with total annual gross revenue of less than $1 billion at IPO registration, and that are not recognized by the SEC as "well-known seasoned issuers" be given up to five years from the date of their IPOs to scale up to compliance. Doing so would reduce costs for companies while still adhering to the first principle of investor protection. (Page 19)

2. **Improve the availability and flow of information for investors before and after an IPO.** We recommend improving the flow of information to investors about emerging growth companies before and after an IPO by increasing the availability of company information and research in a manner that accounts for technological and communications advances that have occurred in recent decades. Doing so would increase visibility for emerging growth companies while maintaining existing regulatory restrictions appropriately designed to curb past abuses. (Page 26)

3. **Lower the capital gains tax rate for investors who purchase shares in an IPO and hold these shares for a minimum of two years.** A lower rate would encourage long-term investors to step up and commit to an allocation of shares at the IPO versus waiting to see if the company goes public and how it trades after its IPO. (Page 30)

In addition to its recommendations for policymakers, the task force has also developed a recommendation for members of the emerging growth company ecosystem:

4. **Educate issuers about how to succeed in the new capital markets environment.** The task force recommends improved education and involvement for management and board members in the choice of investment banking syndicate and the allocation of its shares to appropriate long-term investors in its stock. Doing so will help emerging growth companies become better consumers of investment banking services, as well as reconnect buyers and sellers of emerging company stocks more efficiently in an ecosystem that is now dominated by the high-frequency trading of large cap stocks. (Page 31)

Over the long term, the IPO Task Force believes that enacting these recommended changes will benefit all entrepreneurs who have developed successful, high-growth companies and who qualify for access to public, late-stage growth capital. Each of these action steps is outlined in greater depth in the sections that follow.

> ***"This proposal adds to the ancient rule of caveat emptor, the further doctrine, 'Let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." President Franklin D. Roosevelt, referring to The Securities Act of 1933.***

## A. Recommendation #1:

**Provide an "On-Ramp" for emerging growth companies using existing principles of scaled regulation.**

Our first recommendation is to modify the current framework for IPO issuers and new reporting companies by expanding the system of scaled securities regulation for these emerging growth companies. Congress and the Securities and Exchange Commission (SEC) have had a history of scaling regulation for companies and transactions when warranted, as discussed in the 2006 Final Report of the Advisory Committee on Smaller Public Companies.[1]

In fact, as a result of the 2006 Report and its recommendations, in 2007 the SEC adopted rules providing regulatory relief and simplification for Smaller Reporting Companies (SRCs) in the form of scaled disclosure, noting at the time that scaled disclosure would "promote capital formation for smaller reporting companies and improve their ability to compete with larger companies for capital" as well as reducing their compliance costs and, in turn, the associated "costs to raise capital".[2] The SEC again provided regulatory relief in a 2010 rule exempting smaller companies from the provisions of Sarbanes-Oxley Section 404(b), which requires an auditor attestation of a registrant's internal control over financial reporting.[3]

Similar to these prior reforms, we believe that the modifications we propose for emerging growth companies are "necessary and appropriate in the public interest" and that the adoption of our proposals clearly would "promote efficiency, competition and capital formation".[4] While helpful for companies with market capitalizations of less than $75 million, the existing small company regulations do not provide relief for most companies considering an IPO, including high-growth, venture-backed companies that generate significant job growth like Apple, Intel, Cisco and Genentech before them. These companies go public in order to finance their growth and typically raise between $50 million and $150 million dollars to do so. While still far smaller and with fewer resources than larger companies, they must adhere to the same rules that the very largest companies do and therefore bear compliance costs disproportionate to their size. Based on interviews with pre- and post-IPO companies, we would expect the On-Ramp scaling recommendations that follow to reduce internal and external compliance costs for such companies by 30 percent to 50 percent.

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(1) *See SEC Advisory Committee on Smaller Public Companies, Final Report (2006) ("Advisory Committee Final Report"), Part II, available at http://www.sec.gov/info/smallbus/acspc.shtml.*

(2) *See Release No. 33-8876 (Dec. 19, 2007) at 65 (simplifying the scaled disclosure system and expanding the number of companies that may use the scaled disclosure system available for Smaller Reporting Companies).*

(3) *See Release No. 33-9142 (Sept. 15, 2010); see also Section 989G of the Dodd-Frank Act (providing that non-accelerated filers are completely exempt from Section 404(b) of the Sarbanes-Oxley Act). In addition, all newly public companies, regardless of size, benefit from a phase-in period for Section 404(b) compliance. See Item 308 of Regulation S-K (providing relief for up to two years by permitting newly public companies to wait until their second annual report on Form 10-K to include management's assessment of and the auditor's attestation report on internal control over financial reporting). Separately, Section 404(a) of the Sarbanes-Oxley Act and related SEC rules require all other public companies to provide an annual management's report on internal control over financial reporting.*

(4) *See Securities Act Section 2(b); Exchange Act Section 3(f); Investment Company Act Section 2(c).*

**1.1 Create a new category of issuer, "emerging growth company," that lasts up to five years and is transitional.**

To address the higher relative compliance burdens that emerging growth companies face, and consistent with the concept of scaling regulation, we recommend creating a new category of issuer — an "emerging growth company" — that will be permitted to benefit from a modified regulatory framework that would provide a transitional five year On-Ramp following the IPO.

**1.2 Define an "emerging growth company" according to the following criteria:**

**1.2.1 Designation as an emerging growth company would begin on the effective date of the IPO registration statement of any non-reporting issuer with total annual gross revenue of less than $1 billion as of the end of its most recently completed fiscal year.**

**1.2.1.1 Consideration could be given to limiting emerging growth company status to those issuers that are listing on a national securities exchange.**

**1.2.2 Designation as an emerging growth company would cease on the due date of the first annual report on Form 10-K for the year in which the earliest of the following occurs:**

**1.2.2.1 total annual gross revenue exceeds $1 billion;**

**1.2.2.2 the company satisfies the definition of a "well-known seasoned issuer";[1] or**

**1.2.2.3 the fifth anniversary of the effective date of the IPO registration statement.**

The IPO Task Force believes that the temporary and limited nature of these regulations is important and consistent with other regulatory applications. An analysis of the companies that would have fallen under this regulation over the past five years shows that less than 15 percent of listed companies would be impacted at any one time.[2] For this reason, we refer to this as a regulatory "On-Ramp." We believe that the targeted and temporally limited nature of the proposed On-Ramp distinguishes our recommendation from prior proposals for reform and would affect only a small number of companies relative to total market capitalization. We also note that investor protection concerns are further ameliorated in light of the fact that, as indicated in a 10-year study by Audit Analytics released in May 2011, the incidence of restatement by small companies is proportional to their percentage of the public company population (approximately 60 percent in each case).[3]

We believe that the On-Ramp concept will facilitate the SEC's consideration of the effects of new rulemakings upon efficiency, competition and capital formation[4] and, in the interests of promoting capital formation, we recommend that the SEC use the On-Ramp as standing transition relief for any significant new rulemakings in the future.

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*(1) Securities Act Rule 405 defines a "well-known seasoned issuer" to include, in part, issuers that (i) are eligible for short-form registration on Form S-3 or Form F-3; (ii) have at least $700 million of common equity held by non-affiliates as of a date within 60 days of filing a shelf registration statement, an annual report on Form 10-K or Form 20-F or a registration statement update amendment mandated by Section 10(a)(3) of the Securities Act; and (iii) do not fall within the definition of an "ineligible issuer" or "asset-backed issuer."*

*(2) See Appendix D*

*(3) See Audit Analytics, "2010 Financial Restatements: A Ten Year Comparison" (May 2011) at 17.*

*(4) Cf. Business Roundtable v. SEC (Case No. 10-1305) (D.C. Cir. July 22, 2011).*

**1.3 Build on existing scaled disclosure rules to ease compliance burdens during the transition period while maintaining investor protection.**

We believe that the primary goals of most emerging growth companies that conduct an IPO are to secure capital to grow their businesses and pursue promising new products and innovations, thereby creating jobs and enhancing macroeconomic growth. Providing emerging growth companies with the ability to reduce regulatory compliance costs through scaled regulation and disclosure for a period of time after their IPOs would allow them to achieve those goals and build the resources to satisfy the additional regulatory burdens to which larger, more mature companies are accustomed. We believe this would help ameliorate the effects of regulations that have, over the course of the last decade, significantly and continuously increased the compliance burden associated with public company status and made IPOs more costly and difficult.[1] As the SEC correctly anticipated in 2003, rules relating to the implementation of Section 404 of the Sarbanes-Oxley Act were expected to "discourage some companies from seeking capital from the public markets" because those "rules increase the cost of being a public company."[2] We believe our On-Ramp recommendation would mitigate the effects of these increased costs and encourage emerging growth companies to seek capital from the public markets.

Moreover, we believe that disclosure and governance requirements would remain largely unaffected by our recommendations and that this would ensure adequate investor protection. For example, in connection with undertaking an IPO, all companies would continue to be subject to liability for material misstatements or omissions in the registration statement and prospectus. Further, all companies would remain subject to liability for material misstatements or omissions in their current and periodic reports filed with the SEC. We believe that the existing regulatory regime, as modified by our recommendations, would appropriately balance investor protection and the compliance burden on emerging growth companies.

The idea of an On-Ramp for newly-public companies is not new. The SEC already provides an accommodation for IPO companies in the area of internal control over financial reporting, delaying the management assessment and auditor's attestation of internal control over financial reporting until the company's second Form 10-K.[3] This concept is also incorporated into Rule 10A-3 under the Exchange Act and self-regulatory organization (SRO) listing

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(1) *Release No. 33-7881 (adopting Regulation FD); Release No. 33-8048 (requiring additional disclosures regarding equity awards); Release No. 34-42266 (requiring specific disclosures regarding audit committees); Release No. 34-46421 (requiring accelerated reporting of insider beneficial ownership); Release No. 33-8124 (requiring officer certifications under Sarbanes-Oxley Section 302); Release Nos. 33-8128 & 33-8128A (requiring accelerated filing of periodic reports and disclosure regarding website access to such reports); Release No. 33-8176 (adopting disclosure requirements regarding non-GAAP financial measures); Release No. 34-47225 (restricting officer and director transfers of equity securities during pension fund blackout periods); Release Nos. 33-8177 & 33 8177A (requiring disclosure regarding code of ethics and audit committee financial experts); Release No. 33 8180 (requiring seven-year retention of audit work papers under Sarbanes-Oxley Section 802); Release No. 33 8182 (requiring disclosure regarding off-balance sheet arrangements); Release No. 33-8183 & 33-8183A (requiring audit committee pre-approval of audit and non-audit services, audit partner rotation, auditor reports to audit committees, enhanced disclosure regarding audit and non-audit fees and adopting additional requirements for auditor independence); Release No. 33-8185) (requiring attorneys to report evidence of a material violation of securities laws); Release No. 33-8220 (adopting heightened independent requirements for listed company audit committees); (Release No. 33-8230) (requiring electronic filing and website posting of reports under Exchange Act Section 16); Release No. 33-8238 (implementing Sarbanes-Oxley Section 404 requiring an annual management's report and auditor attestation on internal control over financial reporting); Release No. 33-8340 (requiring disclosures regarding nominating committee functions and security-holder communications); Release No. 33-8350 (adopting guidance regarding management's discussion and analysis of financial condition and results of operations); Release Nos. 33-8400 & 33-8400A (increasing the events reportable on Form 8-K and accelerating the reporting deadline); Release No. 33-8565 (interpreting Regulation M to prohibit certain conduct in connection with IPO allocations); Release No. 33-8644 (adopting accelerated deadlines for periodic reporting); Release Nos. 33 8732 & 33-8732A (adopting additional requirements for disclosures relating to executive compensation, including compensation discussion and analysis); Release No. 33-9002 and 33-9002A (requiring financial statement data in an interactive data format using XBRL technology); Release No. 33-9089 (requiring additional disclosures regarding corporate governance matters in proxy statements); Release No. 33-9106 (providing interpretive guidance regarding disclosure required in respect of climate change issues); Release Nos. 33-9136 & 33-9259 (adopting a implementation of Section 404 of the Sarbanes-Oxley Act were expected to "discourage some companies from seeking capital from the public markets" because those "rules increase the cost of being a public company."*

(2) *Release No. 33-8238 (June 5, 2003) at text accompanying n.174 (adopting rules to implement Sarbanes-Oxley Section 404). At that time, the Commission estimated the annual costs of implementing Section 404(a) to be $91,000 per company, excluding "the costs associated with the auditor's attestation report, which many commenters have suggested might be substantial." Id. In fact, a survey of large public companies complying with the new rules under Section 404 during the first year indicated that compliance cost an average of $4.36 million and 27,000 hours. See Financial Executives International, FEI Special Survey on SOX 404 Implementation (March 2005).*

(3) *See Item 308 of Regulation S-K (providing relief for up to two years by permitting newly public companies to wait until their second annual report on Form 10-K to include management's assessment of and the auditor's attestation report on internal control over financial reporting).*

standards with respect to audit committee composition, Board independence standards and other governance requirements. Moreover, the SEC previously recognized, when it adopted rules to implement Section 404 of the Sarbanes-Oxley Act, that the rules warranted a significant transition period to (a) alleviate "costs and burdens imposed on companies"; (b) give companies "additional time to develop best practices, long-term processes and efficiencies"; and (c) increase time to find "outside professionals that some companies may wish to retain" to facilitate their compliance efforts.[1] Similarly, given the substantial time and resources needed to provide the additional disclosure and meet the compliance requirements that apply to Exchange Act reporting companies, the On-Ramp would provide emerging growth companies with a transition period to allow them to fully implement those requirements. Our recommendation would extend and expand that On-Ramp until the emerging growth company has sufficient internally-generated resources to maintain growth and emerge into a mature public company.

During the On-Ramp period, any issuer that satisfies the definition of an emerging growth company could elect to participate in a system of scaled regulation that would extend to emerging growth companies select elements of the scaled disclosure requirements currently available to SRCs, as well as additional elements of scaled regulation:

**1.3.1** **Financial statement requirements:**

**1.3.1.1** **The ability to satisfy financial statement requirements applicable to registration statements and annual reports by presenting two years of audited financial statements that comply with Article 8 of Regulation S-X.**

**1.3.1.2** **Exemption from the requirement to present five fiscal years of selected financial data under Item 301 of Regulation S-K, subject to phase in described below.**

**1.3.1.3** **Presentation of financial statements for additional fiscal years would be phased in incrementally over time:**

- **At IPO — 2 years audited balance sheets and statements of operations and cash flows, selected financials (a summary table of key financial indicators) for the same two years, (the same as scaled disclosure requirements for Smaller Reporting Companies);**
- **One year later — 3 years audited statements of operations and cash flows and 2 years balance sheets, selected financial data for the same 3 years;**
- **Two years later — same as above plus 4 years selected financial data; and**
- **Three years later — same as above plus 5 years selected financial data.**

**1.3.2** **Selected aspects of scaled disclosure in registration statements and annual reports equivalent to requirements applicable to Smaller Reporting Companies for:**

**1.3.2.1** **Management discussion and analysis (MD&A) requirements under Item 303 of Regulation S-K.**

**1.3.2.2** **Executive compensation disclosure under Item 402 of Regulation S-K.**

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*(1) Release No. 33-8238 (June 5, 2003) at text accompanying n.174.*

**1.3.3** Transition relief from SOX 404b, the outside auditor attestation of internal control over financial reporting under Item 308(b) of Regulation S-K to provide "additional time and defer costs for a newly public company, allowing it to focus on its assessment of internal control over financial reporting without the additional focus of the initial public offering."[1]

**1.3.4** Exemption from administratively burdensome requirements, both currently effective and pending, under the Dodd-Frank Act and related SEC rulemaking, such as:

**1.3.4.1** Say-on-pay, say-on-frequency and say-on-parachute votes under Section 951 of the Dodd-Frank Act.[2]

**1.3.4.2** Final disclosure requirements (when adopted) relating to conflict minerals.[3]

**1.3.4.3** Other substantive governance-related disclosure requirements (when adopted), such as pay-for-performance and CEO pay ratio.[4]

**1.3.5** We recommend that the FASB take steps to allow emerging growth companies to adopt new accounting standards using the same extended effective dates it allows for private companies.[5]

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(1) *Release No. 33-8760 (Dec. 15, 2006) at 47 (implementing a transitional period of up to two years) (citing Sections 12, 13, 15 and 23 of the Exchange Act as statutory authority for such relief). Under similar statutory authority, the SEC repeatedly exempted non-accelerated filers from compliance with Section 404(b) of the Sarbanes-Oxley Act for the cumulative period of approximately eight years between enactment of the Sarbanes-Oxley Act and the Dodd-Frank Act.*

(2) *The SEC has acknowledged the additional burdens that these requirements impose on smaller companies, which is why the SEC exempted smaller companies from the say-on-pay and frequency votes until annual meetings occurring on or after January 21, 2013. See Release No. 33-9178 (Apr. 4, 2011) (concluding that "it is appropriate to provide additional time before Smaller Reporting Companies are required to conduct the shareholder advisory votes on executive compensation and the frequency of say-on-pay votes" based upon "the potential burdens on Smaller Reporting Companies" associated with the requirements for those advisory votes).*

(3) *Release No. 34-63547 (proposing to require conflict minerals disclosure to implement Section 1502 of the Dodd-Frank Act by adding Item 4(a) of Form 10-K and Item 104 of Regulation S-K).*

(4) *Section 953 of the Dodd-Frank Act directs the SEC to adopt rules requiring public companies to provide additional detailed disclosures regarding executive compensation matters, including disclosure of (a) each public company's executive compensation compared to the company's financial performance; and (b) the median total compensation of all employees and the ratio of that amount compared to the CEO's total compensation. As of August 2011, the SEC has indicated that it will issue proposed rules under Section 953 before 2012.*

(5) *Cf. Advisory Committee Final Report at V.P.2 (recommending a similar phase-in period).*

The FASB, over the last several years, has a history of providing an extended period of time for private companies and smaller public companies to adopt new standards. This is particularly important for complex standards and those that, due to their nature, may require significant time to implement. Similar to the On-Ramp for scaled securities regulation, allowing emerging growth companies additional time to adopt new standards would allow them to implement the standards in a careful, thoughtful manner, while still enabling them to concentrate on the growth of the company.

**1.3.6 The PCAOB, or alternatively the SEC, should exempt the auditors of emerging growth companies from the requirements of such auditing standards until the company completes the On-Ramp period. This would allow these companies to focus precious resources on growth, job creation and new product development.**

In implementing new auditing standards, the PCAOB should carefully consider the cost of implementation for emerging growth companies, and other appropriate categories of issuers.

In particular, the PCAOB should consider whether to require the standard in an audit of certain categories of registrants and, if required, whether additional time is necessary for the implementation of the auditing standard for such categories of registrants.

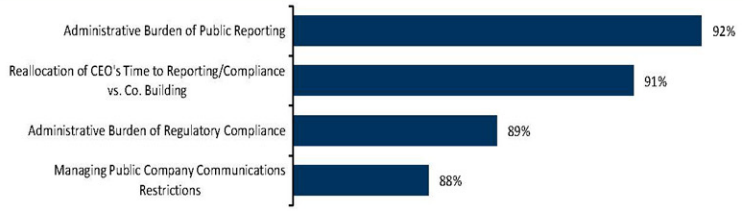
The PCAOB does not yet have a history of providing exemptions or additional time for a certain category(ies) of companies, similar to the FASB, for adoption of new auditing standards.

- Recent concept releases issued by the PCAOB, such as "Auditor Independence and Audit Firm Rotation" and "Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards," if ultimately adopted as auditing standards (depending on the final requirements of course), are likely to be very costly and time-consuming for SEC registrants and their auditors. This is particularly true for emerging growth and small companies who are impacted on a disproportionate basis as these costs represent a larger portion of their revenue and EBITDA and ultimately their market capitalization.

- We believe that mandatory auditor rotation will be extremely disruptive to public companies, will increase audit costs and may even result in reduced audit quality. Several of the PCAOB standards conclude that auditors may consider their experience in prior years' audits of a client and modify or reduce current-year testing as appropriate, which is reasonable to believe occurs in the majority of recurring audits. However, in the first year of a new audit engagement, auditors will require additional time and expense to become familiar with the company. Also, with only four major firms, two situations are likely to occur: (1) many SEC registrants may be limited in the number of firms to choose from as independence issues will most certainly arise, which could reduce the quality of audits if the registrant has no choice but to select a firm that does not have the expertise or geographic reach required for the audit and (2) competition would be significant, which could distract auditors by requiring more frequent solicitation of new business. In addition, each of the Big 4 firms has developed specific regional and industry expertise, which expertise these firms will have less incentive to develop with mandatory rotation. Finally, it is unclear whether rotation will actually reduce the conflicts cited by the PCAOB.

**1.4 Apply scaled On-Ramp regulations only as long as a company qualifies as an emerging growth company.**

**Chart L: Public Company CEOs: Most Significant IPO Challenges**




*Source: IPO Task Force August 2011 CEO Survey.*

## B. Recommendation #2:

**Improve the availability and flow of information for investors before and after an IPO.**

Investment research coverage has declined dramatically in recent years as a result of economic and regulatory pressures that have reduced research budgets. Lack of research coverage adversely impacts trading volumes, company market capitalizations and the total mix of information available to market participants. In addition, existing restrictions on communications surrounding the offering process were designed for a pre-Internet era dependent upon paper-based communications between issuers and investors, and should be updated to reflect advances in technology and market expectations.[1]

**Recommendations**

**2.1 Improve the availability and flow of research coverage.**

Adopt policies to promote research and improve the flow of information available to investors. We recommend a greater role for research in the capital formation process, subject to protections such as specified codes of conduct and disclosure of conflicts of interest and disclosure, consistent with Section 17(b) of the Securities Act of 1933, of any consideration received for paid research. We support and endorse the recommendations of the SEC Advisory Committee on Smaller Public Companies (the "Advisory Committee")[2] regarding policies to encourage research coverage of smaller public companies. Existing limitations are unnecessarily restrictive and unfairly favor institutional investors that have greater access to research analysts than retail investors.

**2.2 Expand and clarify existing safe harbors.**

Expand SEC safe harbors with respect to research reports (Securities Act Rules 137, 138 and 139) to (i) permit broker-dealers to initiate coverage and distribute research on IPO issuers without being deemed to have "offered" securities through the research reports and (ii) include "oral" (in addition to written) communications.[3]

Nearly a decade ago, structural reforms and increased disclosure requirements introduced substantial regulatory requirements for research reports, including Section 501 of the Sarbanes-Oxley Act, Regulation AC and the provisions of the Global Research Analyst Settlement. As a result, analyst research reports are comprehensively regulated and include disclosure to investors regarding potential conflicts of interest that research analysts may face.

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(1) *See SEC Release No. 33-8591 (Dec. 1, 2005), at 41-42 (noting that "the gun-jumping provisions of the Securities Act were enacted at a time when the means of communications were limited," recognizing that "capital markets, in the United States and around the world, have changed very significantly since those limitations were enacted," acknowledging that today's "communications technology, including the Internet, provides a powerful, versatile, and cost-effective medium to communicate quickly and broadly" and concluding that "the gun-jumping provisions of the Securities Act impose substantial and increasingly unworkable restrictions on many communications that would be beneficial to investors and markets and would be consistent with investor protection"); see also SEC Release 34-58288 (Aug. 7, 2008) (recognizing "the speed at which technological advances are developing" and indicating that the SEC will continue to revisit its prior guidance "to update and supplement it as appropriate" as new technologies produce new investor tools); SEC Release No. 34 55146 (Mar. 30, 2007) (observing that "approximately 87.8% of shares voted were voted electronically or telephonically during the 2006 proxy season" and that "approximately 80% of investors in the United States have access to the Internet in their homes").*

(2) *See Final Report of the Advisory Committee to the SEC (April 23, 2006) ("Advisory Committee Report"), Recommendation IV.P.4.*

(3) *Currently available safe harbors contain conditions that limit their availability in the IPO context. See Rule 138 (allowing an underwriter to publish or distribute research about a different security of the issuer, such as research about the nonconvertible debt of an issuer offering common stock, if (a) the issuer is Form S-3 or F-3 eligible (or is a foreign private issuer meeting certain specified criteria); and (b) the underwriter publishes or distributes reports on those types of securities in the regular course of its business); Rule 139 (allowing an underwriter to continue to publish or distribute research, but not to initiate coverage, (a) issuer-specific research on companies that are already public and eligible to use Form S-3 or F-3 (or that are foreign private issuers meeting certain specified criteria) if the underwriter publishes or distributes those reports in the regular course of its business; and (b) industry research for Exchange Act reporting companies if the underwriter publishes or distributes research in the regular course of its business and similar reports have included similar information about the issuer or its securities). In addition, although Rule 137 is available to broker-dealers that are not participating in a registered offering, Rule 137 (unlike Rules 138 and 139), does not provide a safe harbor from the research report being deemed an "offer" for purposes of Securities Act Section 2(a)(10) or 5(c). See Rule 137 (allowing a broker-dealer to publish or distribute research without becoming a statutory underwriter if the broker-dealer (a) is not a participant in a registered offering; (b) has not received compensation for participating in the securities distribution; and (c) publishes or distributes research in the regular course of its business).*

The SEC adopted changes in 2005 that were intended as "measured amendments" making "incremental modifications" to Rules 137, 138 and 139, recognizing that "value of research reports in continuing to provide the market and investors with information about reporting issuers cannot be disputed."[1] However, in practice, the existing rules do not allow research analysts to publish concurrently with an IPO.

We believe that further amendments are warranted to allow broker-dealers to initiate research coverage on IPO issuers, based upon the extensive and robust nature of substantive regulations currently in place, which we would leave unchanged, and based upon experience over the last six years following prior incremental modifications to these rules. Based on "enhancements to the environment for research imposed by recent statutory, regulatory, and enforcement developments," as the SEC explained in 2005, "we believe it is appropriate to make measured revisions to the research rules that are consistent with investor protection but that will permit dissemination of research around the time of an offering under a broader range of circumstances."[2]

**2.3 Eliminate unnecessary research quiet periods.**

**2.3.1 Post-IPO: Eliminate the SEC's effective 25-day post-IPO research quiet period and FINRA's mandated post-IPO research quiet periods, as these restrictions do not benefit investors (particularly retail investors).[3]**

*(1) Release No. 33-8591 (Dec. 1, 2005) at 156-57.*

*(2) Id. at 156.*

*(3) Rule 2711(f) of the Financial Industry Regulatory Authority ("FINRA") prohibits member firms from publishing or distributing research reports, or permitting research analysts to make any public appearance about an issuer, for (i) 40 calendar days, in the case of managers and co-managers of the IPO, and (ii) 25 calendar days, in the case of other participating FINRA members.*

**2.3.2 Pre- and Post-Lock Up: Eliminate the FINRA-mandated research quiet period before and after the expiration, termination or waiver of an offering-related lock-up agreement.**[1] Limiting the amount of information available to investors during such periods does not improve their ability to make informed decisions. In each case above, we believe any potential conflicts of interest would be sufficiently addressed through (a) prominent disclosure clearly indicating that the research is prepared by an analyst associated with a participating underwriter or dealer; as well as through existing protections under (b) SEC Regulation AC certification requirements;[2] (c) FINRA conduct and communications rules and (d) existing antifraud and anti-manipulative provisions.[3]

**2.4 Eliminate unnecessary restrictions on analyst communication:** Although current SEC and FINRA restrictions implemented to prohibit investment banking revenues and considerations from influencing research analysts and the content of research reports are important and should remain, we believe, while an issuer is in registration, that:

**2.4.1 Investment banking personnel should be permitted to assist in arranging calls between investors and research analysts so that research analysts can educate investors about an offering.** Today's process requiring a sales person (or other non-banking personnel) to set up these calls offers no meaningful investor protection. Whether the analyst chooses to engage in the communication, and what the analyst communicates to the investor, would still be at the analyst's own discretion and subject to applicable laws, rules and regulations.[4]

**2.4.2 Research analysts should be permitted to participate in company management presentations with sales force personnel so that the issuer's management does not need to make separate and duplicative presentations to analysts at a time when senior management resources are limited.**[5]

**2.5 Facilitate capital formation by expanding permissible communications between issuers and prospective investors and by providing for confidential IPO filings.**

**2.5.1 Permit a broader range of pre-filing communications:** The SEC has recently recognized, in proposing amendments to Securities Act Rule 163, that additional accommodations are necessary to allow "well-known seasoned issuers," acting through underwriters, to "assess the level of investor interest in their securities before filing a registration statement."[6]

**2.5.1.1 More broadly, we recommend allowing private companies to "test the waters" to gauge preliminary interest among prospective investors in advance of an initial filing of a registration**

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*(1) See FINRA Rule 2711(f)(4) (requiring a 15-day quiet period surrounding the expiration of an offering-related lock-up agreement).*

*(2) Regulation AC requires broker-dealer research analysts to (a) certify in their research reports that the views expressed in the report accurately reflect their personal views; (b) disclose whether the analyst received compensation or other payments in connection with the recommendations or views given in the report; and (c) provide similar certifications in connection with the analyst's public appearances. The SEC adopted these requirements "to promote the integrity of research reports and investor confidence in those reports." Release No. 33-8193 (Apr. 14, 2003).*

*(3) We note that FINRA had previously proposed (i) the reduction of the post – IPO research quiet period to 10 days for all IPO participants, and (ii) the complete elimination of the secondary offering and lock-up related research quiet periods. See FINRA Regulatory Notice 08-55 (October 2008) ("Notice 08-55"); see also SEC Release No. 34-55072 (Jan. 9, 2007) (in which then NASD and NYSE (now FINRA) proposed various rule changes to implement certain recommendations made in the December 2005 "Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules"; the 2007 proposed rule changes included the reduction of the post-IPO research quiet period to 25 days, the elimination of the post-secondary offering research quiet period, and the elimination (as proposed by NASD) or reduction to 5 days (as proposed by NYSE) of the lock-up related research quiet period). Notice 08-55 effectively superseded the 2007 rule change proposals, but the proposals set forth in Notice 08-55 have not yet been adopted and it is likely that FINRA will submit a new rule proposal in this regard in the near future.*

*(4) See, e.g., Rule 2711(c)(7).*

*(5) FINRA Rule 2711 does not, by its express terms, prohibit "three way" meetings attended by company management, research analysts and internal sales personnel, although FINRA guidance issued in May 2005 states that the "rule expressly permits research analysts to educate investors and member personnel about a particular offering or other transaction, provided the communication occurs outside the presence of the company or investment banking department personnel. See FINRA (then NASD) Notice to Members 05-34.*

*(6) Release No. 33-9098 (Dec. 18, 2009) (proposing to amend Securities Act Rule 163 to allow underwriters, acting on behalf of "well-known seasoned issuers," to offer securities before filing a registration statement to gauge investor interest without requiring public disclosure of an intent to conduct an offering).*

**statement.** Doing so would allow companies to remove a significant amount of uncertainty regarding the feasibility of a successful IPO.[1] This approach could be implemented in a balanced manner by adopting a new rule defining certain offering communications as outside the scope of an "offer" for purposes of Section 5 of the Securities Act but otherwise subject to the antifraud provisions of the federal securities laws.[2]

2.5.1.2 **More specifically, we recommend expanding permissible communications before and after filing a registration statement provided prospective investors meet certain qualitative standards and purchasers receive a statutory prospectus prior to purchase.** For example, road shows and other communications should be permitted before the filing of the registration statement becomes public, assuming that confidential filings are permitted as described above.

2.5.2 **We recommend permitting pre-IPO road shows to investors deemed not to require registration-level protection, such as qualified institutional buyers and accredited investors, provided that each purchaser receives a statutory prospectus prior to the time of sale, consistent with Exchange Act Rule 15c2-8 and Securities Act Rule 159.** This would facilitate initial meetings between investors and management and would allow investors to become better prepared to make investment decisions at the time of the IPO. The limited context of a formal road show presentation can make it more difficult for some investors to engage in a meaningful deliberative process, particularly for the type of long-term investors whose participation is most desirable to IPO issuers. Moreover, investors have repeatedly asked for more contact with management during the marketing process.

2.5.3 **Permit confidential initial filing of IPO registration statements:** Permit U.S. issuers to file initial registration statements confidentially, similar to foreign private issuers. The SEC Staff's current practice permits non-reporting foreign private issuers to submit initial registration statements confidentially to the Staff, which "often reviews and screens draft submissions of foreign registrants on a non-public basis."[3] In contrast, U.S. issuers currently must file their initial registration statements publicly. Confidential submissions offer foreign private issuers a significant advantage by facilitating resolution of the often complex issues encountered during an initial SEC review. Permitting the confidential review of U.S. issuers' initial registration statements would remove for U.S. issuers a significant impediment to the IPO process. Doing so would allow U.S. issuers to initiate a potential IPO process, even during turbulent and uncertain market conditions, without immediately disclosing competitively sensitive or otherwise confidential information. Investors would be protected by ensuring that any prospectus with pricing information be made publicly available to investors prior to the SEC declaring the registration statement effective.

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(1) *Securities Act Rule 254 was intended to allow an issuer employing the SEC's "small issues" exemption in Regulation A to use a written statement to gauge investor receptiveness to a possible offering so that the issuer could "determine whether to incur the expense of proceeding with a public offering of its securities . . . or to follow some other capital-raising plan." SEC Release No. 33-6924 (Mar. 11, 1992). In practice, however, Regulation A has had no meaningful impact on capital formation due to its very limited scope. We recommend expanding the "test the waters" concept so that IPO issuers could meaningfully and cost-effectively gauge investor receptiveness to an IPO and determine whether to incur the time, effort and expense of going public.*

(2) *Advisory Committee Report, Recommendation IV.P.5.at 79 n.159 (citing Linda Quinn, "Reforming the Securities Act of 1933: A Conceptual Framework," 10 Insights 1, 25 (Jan. 1996)).*

(3) *See Division of Corporation Finance, "Current Issues and Rulemaking Projects: Quarterly Update" (Mar. 31, 2001), Part V., available at http://www.sec.gov/divisions/corpfin/cfcrq032001.htm#secv.*

## C. Recommendation #3:

**Lower the capital gains tax rate for investors who purchase shares in an IPO and hold these shares for a minimum of two years.**

Recent regulations and subsequent changes in related market practices have made it more difficult for long-term investors to gain access to emerging growth company stocks. From the issuer's perspective, it is especially critical for the IPO to attract such long-term investors at the initial allocation because that determines how much capital the company raises through the IPO.

Policymakers can reinforce demand for emerging growth stocks by lowering the capital gains rate for investors who purchase shares in an IPO and hold these shares for a minimum of two years. The capital gains tax rate has served as an effective tool for encouraging and rewarding long-term investing for decades, so this action would be wholly consistent with current practice.

## D. Recommendation #4:

**Members of the emerging growth ecosystem must educate issuers about how to succeed in the new capital markets environment.**

Regulations and their effects on related market practices have triggered a fundamental change in the structure of the U.S. capital markets. This new market structure has shifted the economics for large investment banks toward high-frequency, short-term trading of large-cap stocks based on volatility and changes in market price, and away from long-term investing in an emerging company's fundamental growth. The result is a radically different and much less hospitable environment for emerging growth IPOs. Some of the drivers of this shift – most notably electronic trading and decimalization – are permanent. Therefore, emerging growth companies looking to go public must develop a greater understanding of the new market's realities, understand how investment banks have shifted their business models to capitalize on these changes, and use this understanding to inform their IPO strategies – including the choice of an investment banking syndicate, the optimal mix of investors at IPO, and the most effective investor communications activities.

***Nearly 90% of pre-IPO emerging growth companies surveyed expressed concern about the size and vibrancy of the small cap buyer universe.***[1]

The IPO Task Force believes that responsibility for aiding issuers in this effort rests not with policymakers, but rather with all participants in the small-company IPO ecosystem. Toward this end, the task force has developed a number of recommendations for issuers that address the most common areas where knowledge deficits exist – based on the task force's findings and input from its members and third-party advisors. While they do not require action on the part of policymakers, the IPO Task Force has included these recommendations below to demonstrate the breadth and the depth of the challenge that emerging growth IPOs now face and the urgency with which the preceding recommendations must be treated.

**4.1 Choice of balanced investment banking syndicate.**

- **4.1.1 Conduct thorough research on potential investment banking partners.**
- **4.1.2 Understand the interplay between boutique firms and the largest advisory firms.**
- **4.1.3 Understand the implications of different investment banking syndicate structures and align incentives around performance.**

**4.2 Increase the issuer's role in the IPO allocation process with the goal to create an optimal mix of investors for the company.**

- **4.2.1 Allocate shares of the initial public offering to a mix of short- and long-term investors.**
- **4.2.2 Put at least one firm in a leadership position (sole or joint book runner) that will allocate stock to long-term holders of your shares versus traders.**
- **4.2.3 Limit the number of investors to whom the IPO shares get allocated.**

**4.3 Improve practice of investor communication.**

- **4.3.1 Conduct pre-IPO road shows and teach-ins with investors long before an IPO.**
- **4.3.2 Provide frequent information to investors post-IPO. This should include attending investor conferences to maintain the relationships and build company exposure.**

(1) *IPO Task Force August 2011 CEO Survey (see Appendix C).*

## VIII. Conclusion

With the U.S. economic recovery stalled, unemployment entrenched at more than 9 percent and global competition ramping up, the time to revive the U.S. IPO market and to jumpstart job creation is now. The IPO Task Force believes that by pursuing the recommendations presented in this report, policymakers can re-energize U.S. job creation and economic growth by helping reconnect emerging companies with public capital – all while enabling the broadest range of investors to participate in the growth of those companies through a healthy and globally respected U.S. capital markets system.

These outcomes are not only consistent with the spirit and intent of the current regulatory regime, but also essential to preserving America's global economic primacy for decades to come. For this reason, the members of the IPO Task Force pledge their continued participation and support of this effort to put emerging companies, investors and the U.S. job market back on the path to growth.

> ***"When I talk to entrepreneurs in emerging international markets today, most of them share a strong desire and stated goal: They want to grow their businesses into large public companies. In the U.S., I often hear the opposite from entrepreneurs – due to the costs, uncertainties and liabilities now involved with going public. They just don't think the rewards are worth it – and that's killing the capital formation cycle we've relied on for so long." Scott Cutler, Sr. Vice President, Global Corporate Group, NYSE Euronext.***

# IX. Appendices

## Appendix A

### About the IPO Task Force

Arising independently from working group conversations at the U.S. Treasury Department's Access to Capital Conference in March 2011, the IPO Task Force aims to illuminate the root causes of the U.S. IPO crisis and provide recommendations to policymakers for restoring access to the public markets for emerging, high-growth companies. It represents the entire emerging growth company ecosystem, including venture capitalists, experienced CEOs, public investors, securities lawyers, academicians and investment bankers. Upon completion of its activities, the IPO Task Force will report its findings and recommendations to the U.S. Department of the Treasury, as well as share this information with the Securities & Exchange Commission, Congress, the Small Business Administration, the Council on Jobs and Competitiveness, the National Advisory Council on Innovation and Entrepreneurship (NACIE), the Startup America Partnership, and the general public.

### Members

We should note the members of the task force listed below participated as individuals and not as representatives of their organizations. Thus, their input for this report and the positions contained herein do not necessarily reflect the views or positions of the organizations for which they work or are affiliated.

**Venture Capitalists:**

- Kate Mitchell – Managing Director, Scale Venture Partners, Task Force Chairman
- Mark Gorenberg – Managing Director, Hummer Winblad Partners
- Tom Crotty – General Partner, Battery Ventures

**Entrepreneurs**

- Magid Abraham Ph.D. – President, CEO and Co-Founder, ComScore
- Josh James – former CEO, Omniture; CEO & Founder of Domo Technologies
- Desh Deshpande – former CEO and Co-Founder, Cascade Communications and Sycamore Networks; Chairman, Sparta Group; and Co-Chair of NACIE

**Securities Attorneys**

- Joel Trotter – Deputy Chair of the Corp. Dept., Latham & Watkins
- Steve Bochner – CEO and Member of the Board of Directors, Wilson, Sonsini, Goodrich & Rosati

**Academicians/Accountants**

- Bill Sahlman – Dimitri V. D'Arbeloff Chair, and Sr. Associate Dean for External Relations, Harvard School of Business
- Carol Stacey – Vice President, S.E.C. Institute
- Charles "Chuck" Robel – former Chairman, McAfee; private investor and retired head of PWC Tech Practice

**Public Investors**

- Karey Barker – Managing Director, Wasatch Advisors

- Henry Ellenbogen – Portfolio Manager, T. Rowe Price

**Investment Bankers**

- Paul Deninger – Sr. Managing Director, Evercore
- Carter Mack – President and Founder, JMP Securities
- Kevin McClelland – Managing Director, Head of Tech. Inv. Banking, JMP Securities
- Brent Gledhill – Head, Global Corporate Finance; Member of Executive Committee, William Blair & Company
- Brett Paschke – Managing Director, Head of Equity Capital Markets, Corp. Finance, Commitment Committee, William Blair & Company

## Appendix B

### Acknowledgments

The IPO Task Force wishes to express its gratitude to the following individuals, whose input and expertise contributed to the preparation of this report. Please note that their appearance on this list does not imply endorsement of this report or its recommendations.

Chuck Newhall, General Partner, Co-Founder, NEA

Dixon Doll, Co-Founder & General Partner, DCM

Mark Heesen, President, NVCA

Duncan Neiderauer, CEO and Director, NYSE Euronext, Inc.

Scott Cutler, Senior Vice President, Global Corporate Group, NYSE Euronext, Inc.

David Weild, Capital Markets Advisor at Grant Thornton; Founder & Chairman of Capital Markets Advisory Partners; former Vice Chairman of NASDAQ

Ed Knight, Executive Vice President, General Counsel, Chief Regulatory Officer, NASDAQ

Bob McCooey, Senior Vice President, NASDAQ

Jeff Cardon, Portfolio Manager, CEO and Director, Wasatch Advisors

Frank Currie, Partner, Davis Polk

Lise Buyer, Founder, Class V Group

Tom Baruch, Founder & Partner Emeritus, CMEA and member of NACIE

Joseph A. Grundfest, Senior Faculty and W.A. Franke Profesor of Law and Business; Arthur and Tom Rembe Rock Center for Corporate Governance, Stanford Law School, Former Commissioner of the S.E.C.

Bob Huret, Founding Partner, FTV Capital

David York, CEO & Managing Director, Top Tier Capital

Herb Wander, Partner, Corporate Practice, Katten Muchin Rosenman LLP

Robert Bartlett, Assistant Professor of Law, Berkeley Law

Greg Becker, President and CEO, Silicon Valley Bank

Various CEOs and institutional investors surveyed by the IPO Task Force

## Appendix C

**IPO Task Force August 2011 CEO Survey**

**Objective and Methodology**

In August of 2011, the IPO Task Force set out to gather the perspectives of pre-IPO and Post-IPO CEOs regarding their top concerns, largest hurdles, and the greatest benefits of going public. The purpose was to inform the task force's efforts to examine the causes of the decline of the U.S. IPO market and develop recommendations for restoring access to capital for emerging growth companies. The task force distributed the survey to pre- and post-IPO companies through the membership of the National Venture Capital Association (NVCA) and by NASDAQ (targeting listed companies that went public since 2006). Responses were collected anonymously during a three-week period in August 2011.

### Post–IPO CEOs: Survey Respondents

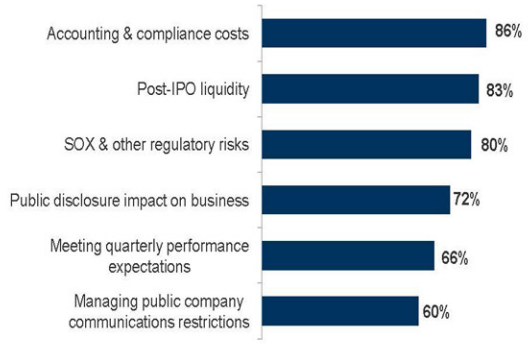
- 35 Public Company CEOs (IPO 2006 or later)
- Industry Sector:
  - –57% IT
  - –29% Life Sciences
  - –9% Non-High Technology
- Average Employment in 2011 = 828
- ***Average job growth since IPO = 86%***

## Public Company CEOs: IPOs Are Important But Increasingly Difficult

| | Agree | Neutral | Disagree |
|---|---|---|---|
| Strong & Accessible IPO Market Is Important to U.S. Economy & Global Competitiveness | 100% | 0% | 0% |
| U.S. IPO Market Is Accessible for Small Companies | 23% | 11% | 66% |
| It Is Not as Attractive an Option to Go Public Today as It Was in 1995 | 86% | 3% | 12% |
| Going Public Was a Relatively Painless Experience | 17% | 14% | 69% |
| Going Public Has Been a Positive Event in My Company's History | 83% | 14% | 3% |

## Why Post-IPO Companies Went Public

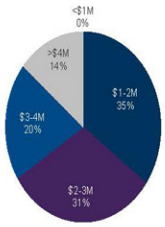
## Post-IPO CEO Survey : Biggest Concerns About Going Public



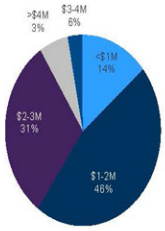

## Public Company CEOs: Most Significant IPO Challenges

## Post-IPO CEO Survey: Costs of Going and Staying Public Are High

**Average Cost $2.5M to Go Public**




**Annual Cost $1.5M to Stay Public**




**Costs Including SOX, Legal, Accounting**

Source: IPO Task Force CEO Survey August 2011. of incremental costs of an IPO. Sample set consists of 35 CEOs of companies that went public since 2006; Consistent With Independent Review of Public Filings for 47 2011 IPO's Raising Less Than $200M (Avg. Cost of $3M for IPO)

## Pre-IPO CEOs: Survey Respondents

- 109 CEOs of venture-backed companies considering an IPO in the next 24 months.
- Average Employment: 168
- Industry Sector Breakdown:
  - 42% IT
  - 11% Cleantech
  - 42% Life Sciences
  - 1% Non-High Technology

## Pre-IPO CEOs Target IPOs To Finance Growth

Source: IPO Task Force CEO Survey August 2011.

## Pre-IPO CEO Sentiments Regarding U.S. IPO Market

| | Agree | Neutral | Disagree |
|---|---|---|---|
| Strong & accessible small cap IPO market is critical to maintain U.S. competitiveness | 94% | 6% | 0% |
| Currently, the U.S. IPO market is easily accessible for small cap companies | 9% | 11% | 79% |
| It is not as attractive an option to go public today as it was in 1995 | 85% | 7% | 8% |

## Pre-IPO CEO Survey: Concerns Regarding Implications of Going Public

**Appendix D**

## Size Of Cohort That Qualifies For Regulatory "On Ramp"

| For companies that went public in the previous 5 years | 6/30/2011 | 2010 | 2009 | 2008 | 2007 | |
|---|---|---|---|---|---|---|
| Number of Companies | | | | | | |
| Less than $1B revenue and IPO less than $700mm | 566 | 558 | 571 | 732 | 777 | |
| *as % of total public companies* | 11% | 11% | 11% | 15% | 14% | |
| Total Market Capitalization at IPO | | | | | | |
| Less than $1B revenue and IPO less than $700mm | $305 | $288 | $279 | $338 | $355 | $B |
| *as % of total market capitalization* | 2% | 2% | 2% | 3% | 2% | |

Sources: Dealogic, Capital IQ, World Federation of Exchanges

## PREPARED STATEMENT OF BARRY E. SILBERT

FOUNDER AND CHIEF EXECUTIVE OFFICER, SECONDMARKET, INC.

DECEMBER 14, 2011

Barry Silbert is the Founder and CEO of SecondMarket, the largest secondary market dedicated to creating liquidity for alternative investments, including private company stock, fixed income, bankruptcy claims and warrants/restricted stock. SecondMarket has over 75,000 registered market participants on its online platform and has conducted billions of dollars in transactions across all of its asset classes.

In 2011, SecondMarket was honored by the World Economic Forum as a Technology Pioneer, recognized by Fast Company as one of the "Ten Most Innovative Companies in Finance" and named as one of Deloitte's Technology Fast 500 companies. Barry was also invited to join Mayor Michael Bloomberg's Council on Technology and Innovation, and was named to Fortune's prestigious "40 Under 40" list. In 2009, Barry was a category winner of Ernst & Young's Entrepreneur of the Year Award and a winner of Crain's Entrepreneur of the Year Award. In addition, SecondMarket was recently named as one of "America's Most Promising Companies" by Forbes.

Prior to founding SecondMarket in 2004, Barry was an investment banker at Houlihan Lokey, where he focused on financial restructurings, mergers and acquisitions, and corporate financing transactions. Barry graduated with honors from the Goizueta Business School of Emory University, and holds Series 7, 24, and 63 licenses.

Barry is a frequent speaker on the topic of trading alternative assets and has appeared in many leading publications, including *The Wall Street Journal, The New York Times, The Washington Post, Financial Times, USA Today* and *Forbes*. Barry has been featured on CNBC, CNN Money, Bloomberg News, and Fox Business News.

Barry is also an active angel investor with investments in a number of exciting startups, including Behind the Burner, ProFounder, RealDirect, Send the Trend, Slated, TapAd, and Vator.tv.

Good morning Chairman Reed, Ranking Member Crapo, and Members of the Committee. My name is Barry Silbert. I am the Founder and CEO of SecondMarket. I am grateful for the opportunity to testify this morning regarding these important subjects.

First, I'd like to describe SecondMarket. Second, I will discuss the problems in the public stock markets that have made the markets inhospitable to growth-stage companies. Next, I will describe the important role that SecondMarket plays in the capital formation process, by affording access to capital for private companies while also providing investors with financial information to make informed investment decisions.

Finally, I will urge passage of the legislation that is being discussed at today's hearing, particularly the bills that support growing private companies on their road to the public markets, while also maintaining a high level of investor protection. Modernizing the antiquated "500 Shareholder Rule," eliminating the ban against general solicitation, and easing the path to the public markets for small-cap companies should be of paramount concern to Congress. These complementary initiatives will make it easier for small private companies to flourish and potentially grow into large public companies. The issues raised in my testimony directly impact startup growth, job creation and American global competitiveness.

### My Background and the SecondMarket History

I was born and raised in Gaithersburg, Maryland, and attended college at Emory University in Atlanta. After graduating in 1998, I started my career as an investment banker at Houlihan Lokey where I worked on some of the most prominent bankruptcies of the last decade, including Enron and WorldCom. Houlihan typically represented creditors, and the experience working on complex, problematic restructurings proved invaluable. It was this experience that led me to the idea for SecondMarket.

Upon emerging from bankruptcy, creditors in Chapter 11 cases would sometimes receive stock in the restructured company that was not saleable in the public markets. These creditors often would contact Houlihan to inquire about selling these instruments. When I asked my colleagues how we could assist the creditors with these sales, it was suggested that I should pick up the telephone, start calling my contacts, and find buyers. I was struck that there was no centralized marketplace for these assets. Thus, the idea for SecondMarket was born: a transparent, centralized marketplace where buyers and sellers could transact in alternative assets.

Having long ago decided I wanted to start my own company, I left my Wall Street job and began drafting a business plan. Although the idea has evolved over time, we have always been committed to the notion of providing transparency and centralization to markets that historically had been fragmented and opaque. I founded SecondMarket in New York City in late 2004, and we opened for business in 2005. We started small and low-tech—just five guys in a tiny office with a few computers and phones.

The first asset class that we focused on was restricted securities in public companies. These are assets such as restricted stock, warrants and convertibles that are issued by public companies but not tradable in the public stock markets. Since that time, SecondMarket has experienced significant growth, and we have added markets for fixed income (*e.g.,* auction-rate securities, mortgage-backed securities, *etc.*), bankruptcy claims and private company stock. These asset classes have unique characteristics, objectives and participants. However, they share the common thread that they are illiquid, alternative investments that benefit from a centralized marketplace.

While we have continued to add new asset classes, the size of our participant base has exponentially grown. At the beginning of 2009, we had 2,500 registered participants on SecondMarket. Today we have well over 75,000 participants and the number is constantly growing. Our technology has also substantially evolved as we have invested millions of dollars into our online platform, which provides centralization and efficiency to improve the user experience and streamline the sales process.

Moreover, we are no longer a few individuals in a small office. SecondMarket now employs over 130 people in New York and San Francisco, and we currently have nearly 25 open positions. I should also note that SecondMarket is an SEC and FINRA registered broker-dealer and operates an SEC-registered Alternative Trading System for its private company stock market.

SecondMarket is the leading marketplace for facilitating transactions in private company stock. We have completed trades in over 50 different companies, including Facebook and Twitter. In 2008, we completed $30 million in private company transactions. In 2009, that number rose to $100 million and in 2010, we saw nearly a four-fold increase in transactional value. To date, we have completed nearly one billion dollars in private company stock transactions. Across all of our asset classes, we have completed several billion dollars in trades.

SecondMarket has emerged as an innovative solution provider. We have helped retirees get liquidity when their auction-rate securities (which were often marketed as a cash equivalent) turned out to be long-term, illiquid investments. We have been part of the sales team working in conjunction with Deutsche Bank to help the Treasury Department sell TARP warrants. And we've helped numerous private companies provide liquidity for their shareholders, many of whom reinvested their money into other startups.

**Problems in the Public Stock Markets**

For several decades, startup companies in the United States followed a similar path: they raised angel capital, a few rounds of venture capital, and went public within 5 years. The vast majority of IPOs were for companies raising $50 million or less, even adjusted for inflation. Smaller companies could thrive in the public markets, with equity research coverage and market makers driving investor interest in growth-stage companies. Over the past 15 years, however, the market structure forever changed and the public markets became inhospitable to smaller companies.

Although SecondMarket is not involved in publishing research, we closely follow research findings from industry observers and analysts.[1] Several factors have been recognized by these market observers as contributing to the problems in the American public stock markets:

- *Online Brokers*—although the introduction of online brokerages helped to make trading less expensive, these online brokers replaced retail brokers who helped buy, sell and market small-cap, under-the-radar public companies. Stockbrokers collectively made hundreds of thousands of calls per day to their clients to discuss small-cap equity opportunities, and the proliferation of online brokerages

[1] *See,* "A Wake-Up Call For America", David Weild and Edward Kim, Grant Thornton Capital Markets Series, Nov. 2009; "Market Structure Is Causing the IPO Crisis—and More", David Weild and Edward Kim, Grant Thornton Capital Markets Series, June 2010; "It's Official: The IPO Market is Crippled—and It Is hurting Our Country", Alan Patricof, *Business Insider*, Jan. 2011; "Wall Street's Dead End", Felix Salmon, *The New York Times,* Feb. 2011; "Welcome to the Lost Decade (for Entrepreneurs, IPOs and VCs)", Steve Blank, July 2010; "U.S. Falls Behind in Stock Listings", Aaron Lucchetti, *The Wall Street Journal,* May 2011.

decimated the profession. Those brokers provided a critical marketing tool for the country's small-cap companies.

- *Decimalization*—stock prices used to be quoted in fractions, and the difference between fractions created profit for firms providing market making, research and sales support to small-cap, public companies. When the markets began quoting prices in decimals, trading spreads were reduced and profits were significantly cut. It became unprofitable to market small-cap equity and remains so today.
- *Sarbanes-Oxley*—the legislation is often blamed for the problems in the public markets, but many observers believe it is not the most significant factor in companies electing to remain private. Nonetheless, corporate compliance with the Sarbanes-Oxley Act has certainly increased costs, especially for smaller public companies.
- *Global Research Settlement*—once the investment banks began funding equity research, conflicts of interest emerged and positive equity reports began to be written for undesirable companies. This issue caused State Attorneys General to get involved, eventually resulting in the global research settlement. While based on sound public policy, the result was that research reports essentially stopped being written for small-cap public companies and, consequently, a significant marketing mechanism for small-cap companies was eliminated.[2]
- *High-Frequency Trading*—although high-frequency traders bring significant liquidity to the public markets, by definition, they require the volume and velocity that can only be found in large public companies. A recent report stated that high-frequency traders conduct almost 75 percent of the trades taking place in the U.S. equity market, and those traders essentially ignore small-cap companies.[3]
- *Average Hold Period*—over the past 40 years, the average time that a public market investor holds stock has dropped from approximately 5 years in 1970, to less than 3 months today. This further highlights the fact that investors are now focusing their attention on short-term earnings performance, versus long-term, business-building initiatives.[4]

Virtually all of these developments emerged from either well-intentioned policy decisions or the natural evolution of the markets in an electronic age. Nonetheless, taken in the aggregate, these (and other[5]) factors have made the public markets undesirable for many companies. These factors are not temporary and are unrelated to the current economic climate. These changes to our public stock markets are permanent and systemic, and the regulatory regime must reflect that permanence.

Throughout the 1980s and 1990s, the regulatory environment and overall market structure actively supported high-growth private companies joining the public markets. From 1991 to 2000, there was an average of 520 IPOs per year, with a peak of 756 IPOs in 1996. Today, the lack of a properly functioning public market structure is strikingly obvious. Since 2001, the United States has averaged only 126 IPOs per year, with 38 in 2008, 61 in 2009 and 71 in 2010.[6]

Companies are electing to remain private longer than in previous decades, and the average time a company remains private has essentially doubled in recent years.[7] Moreover, the profile of companies going public has dramatically changed.

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[2] A SecondMarket analysis of the Russell 3000 (the 3,000 largest U.S. public companies) revealed that companies with a market cap in excess of $10 billion have, on average, 25 different financial analysts covering their stock performance. Conversely, companies with a market cap of less than $500 million are on average covered by only five analysts.

[3] "Institutional Traders Around the World Concerned by High-Frequency Trading, Global Survey Shows", MarketWatch, Sep. 2011 (According to the Tabb Group, almost 75 percent of overall daily equities trading can be attributed to high frequency trading.). "How Small Investors Can Get Stomped" Jason Zweig, *The Wall Street Journal,* Dec. 2011.

[4] "Investing Dying as Computer Trading, ETFs and Dark Pools Proliferate", John Melloy, CNBC, Jan. 2011; "The Trading Game Is Causing the Manic Market", Daniel Indiviglio, *The Atlantic,* Aug. 2011.

[5] "Why Merger Lawsuits Don't Pay", Jessica Silver-Greenberg, *The Wall Street Journal,* Aug. 2011 (Last year, a record 353 lawsuits challenging proposed corporate mergers were filed in State and Federal courts across the U.S., a 58 percent increase from 2009); "A Wild Ride to Profits", Jenny Strasburg, *The Wall Street Journal,* Aug. 2011 ("High-frequency traders benefit from price gyrations and high turnover in securities by moving in and out of holdings.").

[6] "Market Structure is Causing the IPO Crisis—and More," David Weild and Edward Kim, Grant Thornton Capital Markets Series, June 2010.

[7] *Id.*

Today, only the very largest companies are going public, and are receiving the sales and research support needed to successfully navigate the public markets.

Simply put, the lackluster IPO market is not providing the solution for investors and early employees who need liquidity. M&A is an alternative option for companies to obtain liquidity; however, acquisitions often result in job losses and stifled innovation. The growth market is a significant and vital part of the capital formation process, and the systemic failure of the U.S. capital markets to support healthy IPOs inhibits our economy's ability to create jobs, innovate and grow. Clearly, a new growth market must emerge.

**The SecondMarket Solution**

We were first approached about facilitating trades of private company stock in late 2007, when a former Facebook employee contacted us and asked if we could help him sell his shares. He had read about how we facilitated transactions in restricted stock in public companies. Since Facebook was not a public company, the stock was unregistered and Facebook did not have any plans for an IPO. We facilitated that transaction and then spent nearly a year conducting diligence to assess the viability of the market. Once we understood that companies were remaining private much longer than in prior years, and that systemic changes in the public markets made it difficult for companies to go public, we were convinced that we could fill the role of a new growth market.

There is not a "one-size-fits-all" trading model for private companies. Each company has its own goals and objectives. Some companies value control and flexibility, others are more concerned with liquidity and valuation. Our business model is premised on the fact that we will not facilitate transactions in a company's equity unless (and until) we have company authorization.

In that context, we allow companies to dictate the essential elements of their marketplace, such as identifying eligible buyers and sellers, setting the amount or percentage of shares to be sold, and determining the frequency of transactions. Some companies want only former employees to sell, and some want only existing shareholders to buy. Some permit weekly trading, but most prefer to establish quarterly or annual liquidity events.

When a company uses SecondMarket to establish a sponsored liquidity program, we require the company to provide financial disclosures to eligible buyers and sellers, including 2 years of audited financial statements and company risk factors. Companies are increasingly comfortable with the mechanics of our market as they recognize that the confidential information they provide is only available to a company's approved buyers and sellers in a secure, online data room administered by SecondMarket.

Transparency is a critical factor to ensure investor protection and confidence, but transparency does not necessarily mean that anyone can view pricing details and the financial statements of private companies. The cornerstone of transparency is that the actual market participants—the buyers and sellers—have access to information to allow them to make informed investment decisions.

In developing the private company market, SecondMarket has become an important part of the capital formation process. By helping companies provide interim liquidity to shareholders, we essentially operate as a bridge to an IPO for companies that eventually want to go public, or as an alternative option for companies that wish to remain private.

**Outdated Regulations**

SEC Chairman Mary Schapiro has said that the SEC is reviewing the regulatory landscape to lessen the burdens on private companies. In this year's State of the Union address, President Obama ordered a review of all Government regulations. He added: "When we find rules that put an unnecessary burden on businesses, we will fix them."[8] In September, in his address on job creation, the President was even more pointed in his remarks: "We're also planning to cut away the red tape that prevents too many rapidly growing start-up companies from raising capital and going public."[9]

I applaud the focus of the Administration, and I believe that the "red tape" that the President identified can be removed by passing pending legislation that enjoys strong bipartisan support. Rule changes in this area would directly impact companies' ability to access capital more readily and cheaply, help companies retain exist-

[8] Remarks by the President of the United States in the State of Union Address, The White House, Jan. 2011.

[9] Address by the President of the United States to a Joint Session of Congress, The White House, Sep. 2011.

ing employees and hire new ones, and bolster American global competitiveness. At a time when our lawmakers, policy makers, and regulators debate how best to create new jobs, I believe the proposed changes to the regulatory rules could have a major impact on job creation.

It is commonly understood that venture-backed companies fuel job growth in this country,[10] but most people do not appreciate the astounding extent to which the statement is true. In a 2010 study, the Kauffman Foundation noted that startups create an average of three million new jobs annually and the most new net jobs in the United States.[11] The study bluntly states: "Put simply . . . without startups, there would be no net job growth in the U.S. economy."

Thus, it is essential that the regulatory framework recognizes this dynamic and permits these startups to flourish. Policy makers need to understand that any serious effort to create jobs has to address the concerns of entrepreneurs. The Kauffman study concludes by noting that "States and cities with job creation policies aimed at luring larger, older employers can't help but fail, not just because they are zero-sum, but because they are not based on realistic models of employment growth. Job growth is driven, essentially entirely, by startup firms that develop organically . . . effective policy to promote employment growth must include a central consideration for startup firms."

SecondMarket's clients are some of the fastest-growing, most successful technology startups in the United States, and I've developed strong relationships with executives at several of these private companies. These executives are often concerned that they are not ready or able to successfully navigate the public markets. They are also concerned about regulatory hurdles that restrict their ability to remain private. The concerns are varied, but two particular regulatory hurdles often are identified:

- The so-called "500 Shareholder Rule" codified in Section 12(g)(1) of the Exchange Act of 1934, which compels private companies to become public reporting companies once they have exceeded 499 holders of record and have more than $10 million in assets at the end of any fiscal year.
- The prohibition against "general solicitation" and "advertising" in connection with private placements of unregistered securities, which has been broadly interpreted to mean that potential investors must have a preexisting relationship with an issuer or intermediary before the potential investor can be notified that unregistered securities are available for sale.

The shareholder threshold was established in 1964 and initially worked quite well. For many years, companies were going public within a few years of founding, and rarely were concerned about exceeding the shareholder threshold. That is no longer the case.

The pay structure at startup companies generally involves giving employees below-market salaries along with options which vest over several years. The options are an economic incentive that allows employees to realize the financial upside of contributing to a successful startup. The companies prefer to give equity in lieu of cash compensation because startups generally need to conserve capital in order to grow their business. Option holders, in fact, are exempted from being counted as common share owners under the 500 Shareholder Rule, even if the options are vested, so awarding options to employees does not adversely impact the shareholder count until the option holders exercise the options. However, in the new reality of companies taking nearly a decade to go public, option holders are often fully vested well before an IPO, and shareholders who exercise their options hold common stock and are counted towards the 500 shareholder cap.

The significance of this development cannot be overstated. The 500 Shareholder Rule has created a disincentive for private companies to hire new employees, or acquire other businesses for stock, as these private companies are fearful of taking on too many shareholders. Application of the rule also discourages companies from providing equity-based compensation to employees, removing one of the great economic incentives attracting the country's best and brightest employees to startups.

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[10] Venture-backed companies in the United States account for more than 12 million jobs, or 11 percent of the total private sector employment. "Venture Impact: The Economic Importance of Venture Backed Companies to the U.S. Economy", *National Venture Capital Journal and IHS Global Insight,* 2009.

[11] "The Importance of Startups in Job Creation and Job Destruction, Kauffman Foundation Research Series: Firm Formation and Economic Growth", July 2010. Significantly, the study notes that even during poor economic conditions, "job creation at startups remains stable while net job losses at existing firms are highly sensitive to the business cycle."

The 500 Shareholder Rule also directly impacts a company's financing decisions. When a private company raises capital, its management team understands that there are only 500 total "slots" for common stock shareholders—both employee owners and investors. That means limiting the pool of potential individual and institutional investors that will have access to the investment opportunity.

There has been recent discussion (and confusion) about the mechanics of counting shareholders for public and private companies, and the distinction between "holders of record" and "beneficial owners." Today, the vast majority of securities of publicly traded companies are held in "street name" rather than directly by the actual owners, meaning that the name of brokers who purchases securities on behalf of their clients (rather than the actual owners) are listed as holders of record. A broker may own stock on behalf of several dozen or several thousand beneficial owners, but because the shares are held in street name, the broker is considered as only one holder of record.

Some have speculated that this paradigm exists for private companies, and allows private companies to have far more than 499 beneficial owners. However, private companies are in an entirely different situation. Private companies closely manage their investor base and typically place restrictions on the sale of shares, and they do not want brokers holding stock on behalf of individuals unknown to the companies. Shareholders of private companies directly own the shares and, thus, there generally is no distinction between the number of holders of record and beneficial owners.[12] Regardless, if a private company attempted to use a broker or an investment vehicle to circumvent the 500 Shareholder Rule, the SEC could use the "anti-evasion" rule in Section 12(g)(5)(1) of the Securities Act to require companies to count the beneficial owners as holders of record.[13]

The prohibition against general solicitation is similarly problematic. Under many of the existing SEC private placement exemptions, only "accredited investors" are eligible to purchase private company stock. An individual must meet certain financial standards to qualify as an accredited investor. The SEC and Congress recognize that sophisticated, accredited individual and institutional investors have greater capacity for risk and do not require the enhanced protections provided to the average retail investor.

As previously noted, the prohibition against general solicitation and advertising requires that issuers and intermediaries have a preexisting relationship with the accredited investor in order to make offerings available. In fact, if a nonaccredited individual is even aware of an offering of unregistered securities, the entire offering may be at risk due to the prohibition against general solicitation.

Frankly, if only accredited investors are eligible to purchase unregistered securities, shouldn't we strive to maximize the pool of accredited investors that have access to the offering? It should not matter that nonaccredited individuals know that unregistered securities are available for sale. No one prohibits car manufacturers from advertising, even though children under the legal driving age are viewing the advertisements, and pharmaceutical companies are free to advertise to people who do not have (and are not eligible for) prescription medication. The general solicitation prohibition unnecessarily limits the pool of potential investors, thereby restricting companies' ability to raise capital to fuel growth.

Currently, all buyers on SecondMarket must be accredited investors (even in asset classes where it is not a regulatory requirement). Should the ban on general solicitation be eliminated, we would support an SEC effort to mandate a more stringent onboarding process for all market participants to ensure that accredited investors meet the eligibility requirements. In fact, to that end, we have actively been exploring strengthening our internal onboarding and verification processes to exceed current SEC requirements.

I believe that all of the capital formation bills being considered by Congress (*e.g.,* creating a crowdfunding exemption and increasing the cap on "mini offerings" under Regulation A from $5 million to $50 million) are important for our country's entre-

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[12] Meredith Cross, the Director of Corporate Finance at the SEC, recently testified before this Committee that the "beneficial owner" issue is unique to publicly traded companies. She said the shift to brokers holding public company stock in street name on behalf of investors "means that for most publicly traded companies, much of their individual shareholder base is not counted under the current definition of 'held of record.' Conversely, the shareholders of most private companies, who generally hold their shares directly, are counted as 'holders of record' under the definition." Testimony on "Spurring Job Growth Through Capital Formation While Protecting Investors" before the Committee on Banking, Housing, and Urban Affairs, p. [50], Dec. 1, 2011.

[13] "If the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of Section 12(g) or 15(d) of the Act, the beneficial owners of such securities shall be deemed to be the record owners thereof." Section 12(g)(5)(1), Securities Act of 1934.

preneurs and will help improve access to capital for startups. However, I wish to focus on three of the bills that I believe warrant immediate passage by this Congress:

1. "The Private Company Flexibility and Growth Act" (S. 1824), which increases the 12(g)(1) shareholder threshold from 500 to 2,000 record holders, and includes an exemption that would exclude current and former employee-shareholders from the shareholder count. The bill also contains a provision to allow publicly traded community banks to deregister from the SEC if they have less than 1,200 record holders. Significantly, this provision does not apply to other publicly traded companies (*i.e.*, nonbanks).
2. "The Access to Capital for Job Creators Act" (S. 1831), which eliminates the ban against general solicitation and advertising in the context of issuer private placements provided that the ultimate purchaser qualifies as an accredited investor.
3. "The Reopening American Capital Markets to Emerging Growth Companies Act of 2011" (S. 1933), which establishes a new category of issuers, called "emerging growth companies" that have less than $1 billion in annual revenues at the time they register with the SEC, and less than $700 million in publicly traded shares after the IPO. The legislation creates an "on-ramp" for companies to help them go public.

These extremely important pieces of legislation complement each other well. The effort to ease the path to the public markets for companies is an essential policy objective, and Kate Mitchell and her colleagues on the IPO Task Force have done an extraordinary job formulating a commonsense strategy to address IPO problems. However, Congress also needs to recognize that even with an easier on-ramp process towards an IPO, companies will continue to remain private longer than in past decades. The structural problems that exist in the public markets—short-term trading fueled by computers, the lack of research coverage for small-cap companies, the focus on beating quarterly earnings projections, even the meteoric rise in shareholder derivative lawsuits—will continue to exist. These and other factors have whittled away the public's trust and confidence in the public stock markets, and have made entrepreneurs such as myself less interested in taking their companies public.

Thus, it is equally important that Congress modernizes the 500 Shareholder Rule to give private companies the flexibility to create more jobs, compensate employees with equity, and raise capital from a broader group of investors. A review of the Congressional cosponsors of these bills underscores that many members understand the importance of passing these bills—there is significant overlap in both the House and Senate sponsorship.

There is also broad private sector support for modernizing the 500 Shareholder Rule. We submitted a letter to Congressional leadership and Members of this Committee endorsed by some of the leading technology entrepreneurs, venture capitalists and angel investors in the country urging Congress to immediately pass this important legislation. Outside of the technology sector, companies and advocacy groups across a wide range of industries throughout the country have submitted endorsement letters to Congress.

Moreover, modernizing the shareholder rule and eliminating the ban against general solicitation are not new concepts: industry experts and participants have advocated for implementing these changes for many years.[14] In 2009, the SEC kindly invited me to participate in its Small Business Capital Formation Forum. I accepted the invitation and participated on a panel regarding the state of small business capital formation. I also listened to multiple panelists advocate for these changes. In fact, for several years, the Forum's participants have recommended that the SEC increase the shareholder threshold, and for over a decade the participants have recommended that the SEC eliminate the ban against general solicitation in the context of private placements.

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[14] *See, e.g.,* Final Report of the SEC Government-Business Forum on Small Business Capital Formation to the United States Securities and Exchange Commission, Nov. 2010, Sep. 2009, Nov. 2008, Sep. 2005, Sep. 2004, Dec. 2003, Feb. 2002, May 2001 (advocating eliminating the prohibition against general solicitation); Nov. 2010, Sep. 2009, Nov. 2008 (advocating exemption of accredited investors from the shareholder limit); Nov. 2010, Sep. 2009 (advocating increasing the 500-shareholder limit).

**Conclusion**

In summary, I want to thank Chairman Reed, Ranking Member Crapo, and the Members of the Committee for the opportunity to participate in this important Hearing.

December 12, 2011

The Honorable John Boehner
Speaker of the House of Representatives
1011 Longworth House Office Building
Washington, DC 20515

The Honorable Harry Reid
Senate Majority Leader
522 Hart Senate Office Building
Washington, DC 20510

The Honorable Eric Cantor
House Majority Leader
303 Cannon House Office Building
Washington, DC 20515

The Honorable Mitch McConnell
Senate Minority Leader
317 Russell Senate Office Building
Washington, DC 20510

The Honorable Nancy Pelosi
House Minority Leader
235 Cannon House Office Building
Washington, DC 20515

**Re: Passage of H.R. 2167 and S. 1824**

Dear Members:

We are writing this letter to strongly urge Congress to pass legislation that will modernize the decades-old "500 Shareholder Rule." The rule, implemented in 1964, compels private companies to become public reporting companies once they exceed 499 shareholders and have more than $10 million in assets. The 500 Shareholder Rule is outdated, overly restrictive, and limits U.S. job creation and American global competitiveness. We are encouraged that some policymakers are exploring ways to stimulate job growth by supporting revenue-neutral legislation in a bipartisan way.

For several decades, startup companies in the U.S. followed a familiar path -- they raised angel capital, a few rounds of venture capital, and went public within five years. However, in recent years, the public markets have become inhospitable to smaller public companies, causing the timeline for going public to increase to nearly a decade. Given the much longer timeline for startups, regulations such as the 500 Shareholder Rule should be modernized.

The pay structure at these startups generally involves providing employees with stock options that vest over several years. These options serve as an economic incentive that enables employees to realize the financial upside of contributing to a successful startup. Awarding options to employees does not adversely impact the shareholder count until the holders exercise the options. However, option holders today are often fully vested well before an IPO, and shareholders who exercise their options are then counted towards the shareholder cap.

Thus, the 500 Shareholder Rule has created a disincentive for private companies to hire and/or provide equity-based compensation to new employees. Companies are also discouraged from acquiring other businesses for stock, for fear of taking on too many shareholders.

Further, the 500 Shareholder Rule directly impacts a company's financing decisions. When a private company raises capital, its management team understands that there are only 500 total "slots" for shareholders -- both employee owners and investors. That means limiting the pool of potential individual and institutional investors that have access to the investment opportunity.

Fortunately, bipartisan bills have been introduced in the House and Senate to modernize the 500 Shareholder Rule. Reps. Schweikert (R-AZ) and Himes (D-CT) introduced H.R. 2167, "The Private Company Flexibility and Growth Act," which was unanimously approved by the House Financial Services Committee. The Senate version of the same name (S. 1824) was recently introduced by Sens. Toomey (R-PA) and Carper (D-DE). Both bills would exempt current and former employees from the shareholder count. The House bill also increases the threshold to 1,000 shareholders while the Senate version increases the count to 2,000. These bills would provide companies with the requisite flexibility to go public when it makes strategic sense for the companies.

We note that in a 2010 study, the Kauffman Foundation determined that startups create an average of three million new jobs annually and the most new net jobs in the United States. The study bluntly states: "Put simply…without startups, there would be no net job growth in the U.S. economy." At a time when our lawmakers, policymakers and regulators debate how best to create new jobs, support of this legislation could have a major impact on job creation.

We hope that Congress will pass legislation to modernize the 500 Shareholder Rule as quickly as possible.

Sincerely yours,

Scott Abel
Spiceworks
CEO
Austin, TX

Ryan Allis
iContact
Founder and CEO
Raleigh, NC

Jeffrey Bussgang
Flybridge Capital Partners
General Partner
Boston, MA

Jason Calacanis
Mahalo
Founder and CEO
Culver City, CA

Jeff Clavier
SoftTech VC
Managing Partner
Palo Alto, CA

Dick Costolo
Twitter
CEO
San Francisco, CA

Angus Davis
Swipely
Founder and CEO
Providence, RI

Mary Dent
SVB Financial Group
General Counsel
Santa Clara, CA

Jack Dorsey
Square
CEO and Chairman
San Francisco, CA

Brad Feld
Foundry Group
Managing Director
Boulder, CO

Rand Fishkin
SEOmoz
Co-Founder and CEO
Seattle, WA

Jennifer Fleiss
Rent the Runway
Co-Founder and President
New York, NY

Tony Florence
New Enterprise Associates
Partner
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Dave Gilboa
Warby Parker
Co-Founder and CEO
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Dave Goldberg
SurveyMonkey
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Palo Alto, CA

James Guiterrez
Progreso Financiero
Chairman and CEO
Menlo Park, CA

Peter Harrison
GlobalLogic
CEO
McLean, VA

Kevin Hartz
Eventbrite
Co-Founder and CEO
San Francisco, CA

Justyn Howard
Sprout Social
President and CEO
Chicago, IL

Philip James
Lot18
Founder and President
New York, NY

Eric Koester
Zaarly
Founder and CMO
San Francisco, CA

Chris Larsen
Prosper
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Mike Lazerow
Buddy Media
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Lawrence Lenihan
FirstMark Capital
Managing Director
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Howard Lerman
Yext
Co-Founder and CEO
New York, NY

Dana Mauriello
ProFounder
Co-Founder and President
Los Angeles, CA

Dave McClure
500 Startups
Founding Partner
San Francisco, CA

Mike McCue
Flipboard
Co-Founder and CEO
San Francisco, CA

Chamath Palihapitiya
Social + Capital
Managing Partner
San Francisco, CA

Alan Patricof
Greycroft Partners
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Alex Rampell
TrialPay
Co-Founder and CEO
Mountain View, CA

Naval Ravikant
AngelList
Co-Founder
San Francisco, CA

Niel Robertson
Trada
CEO
Boulder, CO

Kevin Ryan
Gilt Groupe
Founder and CEO
New York, NY

Barry Silbert
SecondMarket
Founder and CEO
New York, NY

Bill Strauss
ShoeDazzle
CEO
Los Angeles, CA

Jon Teo
General Catalyst Partners
Managing Director
New York, NY

David Tisch
TechStars New York
Managing Director
New York, NY

## PREPARED STATEMENT OF STEPHEN LUPARELLO

VICE CHAIRMAN, FINANCIAL INDUSTRY REGULATORY AUTHORITY

DECEMBER 14, 2011

Chairman Reed, Ranking Member Crapo, and Members of the Subcommittee, I am Steve Luparello, Vice Chairman of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

### FINRA

FINRA is the largest independent regulator for all securities firms doing business in the United States, and, through its comprehensive oversight programs, regulates the firms and professionals that sell securities in the United States and the U.S. securities markets. FINRA oversees approximately 4,500 brokerage firms, 163,000 branch offices and 636,000 registered securities representatives. FINRA touches virtually every aspect of the securities business—from registering industry participants to examining securities firms; writing rules and enforcing those rules and the Federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities and administering the largest dispute resolution forum for investors and registered firms.

In 2010, FINRA brought 1,310 disciplinary actions, collected fines totaling $42.2 million and ordered the payment of almost $6.2 million in restitution to harmed investors. FINRA expelled 14 firms from the securities industry, barred 288 individuals and suspended 428 from association with FINRA-regulated firms. Last year, FINRA conducted approximately 2,600 cycle examinations and 7,300 cause examinations.

FINRA's activities are overseen by the SEC, which approves all FINRA rules and has oversight authority over FINRA operations.

### Protection of Retail Investors by the Federal Securities Laws

As a general matter, and depending upon the transaction, the Federal securities laws provide the following types of protection to retail investors:

- *Antifraud Authority*—The Federal securities laws prohibit various forms of fraud, including fraudulent, deceptive or manipulative practices in connection with the purchase or sale of a security. For example, Rule 10b-5 under the Securities Exchange Act of 1934 has been used successfully to combat a broad range of abusive practices, such as insider trading and market manipulation.
- *Disclosure*—For many transactions, the Federal securities laws require disclosure about the issuer and the securities being sold. For example, the Securities Act of 1933 generally requires that publicly offered securities be sold through a prospectus that provides important information about the securities, the company's management and operations, and the risks of buying the securities.
- *Regulation of Intermediaries*—The Federal securities laws regulate securities intermediaries. For example, the Securities Exchange Act of 1934 generally requires the registration of any firm or individual who is in the business of selling securities as agent or principal, and subjects retail brokers and dealers to FINRA's rigorous examinations and oversight. In general, a person who is offering investment advice must register with the SEC under the Investment Advisers Act of 1940 or with the States.
- *Qualification of Investors*—The level of regulation provided by the Federal securities laws will often depend upon the sophistication or wealth of the investor. For example, Rule 506 of Regulation D provides a safe harbor from registration for securities sold to an unlimited number of "accredited investors," who meet certain thresholds of net worth or income, and up to 35 nonaccredited investors. The rule also requires that any unaccredited investors to whom the securities are sold must have enough investment experience and knowledge to make an informed decision about the merits and risks of the investment.
- *Market Regulation*—The Securities Exchange Act of 1934 and the regulation of the stock exchanges and other market participants by the SEC and FINRA establish standards that are designed to protect the integrity of the public markets.

The Federal securities laws are intended to achieve at least two objectives. First, they are designed to protect customers from abusive or fraudulent practices. Second, and equally important, they are intended to provide the investing public with confidence that market participants will treat customers fairly.

This testimony will address FINRA's regulation of intermediaries. From the perspective of a less sophisticated, retail investor, an intermediary can appear objective in its selection of securities to offer and reliable in its completion of the investor's securities transaction. Perhaps in recognition of this relationship, Rule 506 of Regulation D requires that each nonaccredited investor, "either alone or with his purchaser representative(s)," have a specified degree of financial sophistication.

These assumptions by a retail investor about the professionalism of a securities intermediary necessitate that an intermediary be subject to adequate oversight by a securities regulator. In the course of our work, FINRA examines registered broker-dealers for compliance with the securities laws, SEC rules and our own rules. Of course, the particular requirements applicable to an intermediary should partly depend upon the nature of the intermediary's business. FINRA thus makes every effort to tailor its oversight according to the various business models within the broker-dealer industry.

In response to the Subcommittee's request, we are focusing the following discussion on the private placement and microcap markets. Given that the private placement market is a relevant analogy to a number of the capital-raising constructs currently under consideration, we believe our experience with that market and the issues and regulatory problems that we have found in that area may be particularly helpful to the Subcommittee.

**The Private Placement Market**

The private placement market is an essential source of capital for American business, particularly small firms. Regulation D under the Securities Act of 1933 provides the most important avenue for a company to privately issue shares. According to one estimate, in 2008 companies intended to issue approximately $609 billion of securities in Regulation D offerings.[1] While the private placement market is an important source of capital for many U.S. companies, the Federal securities laws permit issuers to privately place their securities directly with qualified purchasers, without necessitating the protections of a regulated intermediary, and with limited or no disclosure about the company. In our oversight of broker-dealers that participate in Regulation D offerings, FINRA has uncovered fraud and sales practices abuses. Recently, for example, FINRA sanctioned a number of firms and individuals for providing private placement memoranda and sales material to investors that contained inaccurate statements or omitted information necessary to make informed investment decisions.

As a response to these problems, in 2010 FINRA issued guidance to firms concerning their participation in Regulation D offerings. The Notice reminded firms that FINRA's suitability rule requires that a broker-dealer conduct a "reasonable investigation" concerning recommended Regulation D offerings. The guidance also made clear that the requirement to conduct a reasonable investigation is a duty of a broker-dealer that arises from a long history of case law under the antifraud provisions, and under FINRA's just and equitable principles of trade. This duty requires the broker-dealer to understand the Regulation D securities and to take reasonable steps to ensure that the customer understands the risks and essential features of those securities.

In October, FINRA filed with the SEC proposed rule amendments to ensure that firms make basic disclosures about private placements that they recommend to their retail customers. This proposal, which is still pending at the SEC, would require firms to disclose the anticipated use of offering proceeds, the amount and type of offering expenses, and the amount and type of compensation to be paid. The proposed rule amendments also would require "notice" filings with FINRA of a broker-dealer's private placement activities.

**Microcap Markets and Fraud**

Microcap issuers are companies with low levels of capitalization. Often they are startups or shell companies whose stock is thinly traded in the over-the-counter market. Some may be private issuers whose shares became eligible for trading in the over-the-counter market. Others may have originally issued their shares through an exemption from registration, such as Regulation D, but have since become public companies through a reverse merger with a shell company or through other means.

Even the microcap issuers whose shares have been registered under the Securities Act of 1933 can present particular risks to retail investors. These companies may not be followed by independent financial analysts, their shares may be thinly trad-

[1] Office of the Inspector General, Securities and Exchange Commission, Regulation D Exemption Process 2 (March 31, 2009).

ed, and the publicly available information about the company may not provide a sufficient basis to evaluate the company's claims about its business prospects.

During the last 2 years, FINRA has referred more than 500 matters involving potential microcap fraud to the SEC. For example, in one matter the SEC suspended trading in a purported power company and charged several of its executives with inflating the price of its stock by issuing a barrage of press releases touting the company, including claims that it was building a $10 billion nuclear power plant. In fact, the company, which went public through a reverse merger, had essentially no revenue or operations. The SEC also alleged that the company falsely claimed that its management had such confidence in the company that they had not sold any of its stock; records obtained by the SEC showed that two senior executives had secretly unloaded extensive stock holdings.

Fraudulent schemes in microcap stocks often seek to exploit well-publicized news events or trends. After the Japanese tsunami, FINRA warned investors about scams involving companies that claimed to offer products or services for detecting gamma rays or cleaning up nuclear waste. FINRA has also referred matters to the SEC involving stocks linked to China, the Gulf oil spill, gold, and clean energy.

**FINRA's Office of Fraud Detection and Market Intelligence**

Many of the referrals noted above originate in FINRA's Office of Fraud Detection and Market Intelligence (OFDMI). OFDMI's mission is to ensure that allegations of serious fraud received by FINRA in the form of complaints, regulatory filings and other sources are subjected to a heightened review. OFDMI serves as a centralized point of contact on fraud issues, within FINRA and externally with other regulators and the public. The creation of OFDMI has expedited fraud detection and investigation, by pursuing matters as far as possible and by referring cases that fall outside of FINRA's scope to the appropriate authorities.

So far this year, OFDMI has referred more than 600 matters involving potential fraudulent or illegal conduct to the SEC or other Federal law enforcement agencies for further investigation. In 2010, OFDMI made more than 550 referrals. These matters involved a wide range of issues, including insider trading, microcap fraud and Ponzi schemes.

Through the Central Review Group unit, OFDMI has centralized the receipt, analysis and distribution of tips, complaints and referrals from the public and other regulators. In addition, OFDMI has implemented a comprehensive prioritization system that is used across all of FINRA's regulatory operations. This operational enhancement means that serious matters are escalated and investigated more quickly.

FINRA's Office of the Whistleblower, first established in March 2009, continues to receive and process, on an expedited basis, a significant amount of incoming information. As of November 2011, the office has received and triaged over 180 substantive calls to its hotline, and another 180 reviews were initiated from emails received via a dedicated email address. The office made 37 formal referrals to the SEC or other law enforcement agencies, and another 54 internal referrals. As a result, 12 registered representatives have been permanently barred from the securities industry, with an average of 135 days from the receipt of the matter to the imposition of the bar.

As of November 30, 2011, the Fraud Surveillance unit of OFDMI has referred 277 matters to the SEC this year. The referrals include matters involving issuer fraud, pump-and-dump schemes, market manipulation and account intrusions. During the same time period, OFDMI's Insider Trading Surveillance unit made 285 insider trading referrals to the SEC, the highest in FINRA's history. The referrals included suspicious trading ahead of material news announcements by hedge funds, institutional investors, private equity funds and retail investors.

Beyond the establishment of OFDMI, FINRA also has enhanced its examination programs and procedures in a variety of ways intended to help us better detect conduct that could be indicative of fraud. Our examination teams are expected to focus most on those areas at firms that pose a real risk to investors. FINRA staff created an "Urgent" designation for those regulatory matters posing the greatest potential for substantial risk to the investing public. Urgent matters are expedited and then reviewed to make certain that the right level of resources and expertise are assigned to them, and to ensure there is coordination and information sharing across FINRA departments. We also have increased the number of staff in our district offices tasked with in-depth and ongoing understanding of specific firms, including increased real-time monitoring of business and financial changes occurring at a firm. This expansion has enhanced our staff's ability to evaluate available regulatory information and to target examinations based on that information.

**Investor Education**

Investor education is a critical component of investor protection and FINRA is uniquely positioned to provide valuable investor education primers and tools. FINRA sponsors numerous investor forums and outreach programs, and our Web site is a rich source of such material, including investor alerts, unbiased primers on investing and interactive financial planning tools. In addition to the investor education activities of FINRA itself, the FINRA Investor Education Foundation is the largest foundation in the United States dedicated to investor education.

Relative to the issues we are discussing today, FINRA has produced investor alerts that clearly explain the characteristics of the most commonly used securities frauds, including Ponzi and pyramid schemes, pump-and-dumps and offshore scams. For example, a range of investor alerts issued just this last year warned investors about:

- gold stock scams that mine investors' pocketbooks;
- fraudulent schemes exploiting the tsunami and nuclear crises in Japan; and
- pre-IPO scams purporting to offer access to shares of Facebook and other popular, well-known private companies.

Drawing on ground-breaking research supported by the FINRA Investor Education Foundation, we have delivered dozens of investor seminars that explore who is at risk, how to recognize the psychological persuasion tactics used by fraudsters to lure in their victims—tactics that are constant across a wide variety of frauds—and what simple, actionable steps investors can take to avoid investment scams. To reach an even wider audience, the FINRA Foundation produced an award-winning documentary, *Trick$ of the Trade: Outsmarting Investment Fraud,* which has aired more than 740 times on 170 public television stations in 30 States since September 2010.

A key theme of our investor protection initiatives is "Ask and Check." We encourage investors to find out whether an investment professional is licensed—and to verify the information using FINRA's BrokerCheck system. BrokerCheck allows investors to quickly access information about the disciplinary history, professional background, business practices and conduct of the brokerage firms and individual brokers with whom they invest. While dealing with a licensed professional isn't a guarantee against fraud, most investment scams tend to involve unlicensed professionals touting unregistered securities.

**Conclusion**

We appreciate the Subcommittee's continued focus on improving access to capital for startups and small businesses while continuing to provide protections for investors. We hope that sharing our experiences in dealing with regulatory challenges in private offerings provides useful insight as the Subcommittee continues its evaluation of the many bills pending relative to this issue. As noted above, Federal securities law and SRO rules provide protection for retail customers through five primary mechanisms—antifraud authority, disclosure, regulation of intermediaries, qualification of investors, and market regulation. The legislative proposals currently under consideration attempt to build in some or all of these mechanisms in various ways. We would be happy to continue to work with the Subcommittee and its Members as you consider how best to balance the goals of providing new opportunities for building capital and protecting investors.

Again, I appreciate the opportunity to testify today. I would be happy to answer any questions you may have.

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## PREPARED STATEMENT OF MARK T. HIRAIDE

PARTNER, PETILLON, HIRAIDE & LOOMIS, LLP

DECEMBER 14, 2011

Chairman Reed, Ranking Member Crapo, distinguished Members of the Committee, thank you for the opportunity to appear here today to discuss investor risks in capital raising.

My name is Mark Toshiro Hiraide. I am a partner in the law firm of Petillon Hiraide & Loomis LLP, in Los Angeles, California. I have been in private practice since forming the firm with my partners in 1994, after serving 8 years as an attorney for the Securities and Exchange Commission.[1] Since leaving the Commission

[1] I joined the Commission's Division of Enforcement, as an attorney and later Branch Chief, in the Los Angeles Regional Office from 1986 to 1989. From 1990 to 1994, I served as an Attor-

over 17 years ago, I have spent my career as legal counsel to entrepreneurs and small and mid-sized public companies, assisting them in private and public securities offerings. My practice includes defending officers and directors in civil litigation arising out of securities offerings and merger and acquisition transactions and prosecuting civil claims on behalf of aggrieved investors. I also practice before the SEC and FINRA in regulatory defense matters. Relevant publications include the legal treatise, "Representing Start-Up Companies," published by Thomson Reuters, of which I am a coauthor, and the "Guide to California Securities Practice" published by the Corporations Committee of the Business Law Section of The State Bar of California for which I served on the Editorial Committee.

**The Funding Gap**

The importance of early-stage capital to our economy, and the challenges to entrepreneurs in accessing it, even prior to the recent economic downturn, has been well documented.[2] Recent events have made it even more difficult for new companies requiring seed capital to attract it. Home equity, traditionally a source of capital for seed stage investors, has diminished with the deep decline in real estate prices. Moreover, continuing economic uncertainty has caused many early-stage investors to be risk averse.

In my experience, a start-up's first seed capital investment of $250–$500,000 is critical to the development a health equity market "food chain." This initial funding level allows technologies and concepts to be validated. Without such validation, it is often difficult for our client entrepreneurs even to be considered by professional venture capital and Angel investors.

According to a recent survey, 76 percent of 253 investment bankers surveyed said that the number of companies with $1 million EBITDA (a company's earnings before the deduction of interest, tax, and amortization expenses) who are worthy of investment exceeds the amount of capital available (whereas, only 58 percent of the investment banked respondents said the capital available exceeds the number of companies with $100 million EBITDA that meet investment criteria).[3]

Can the Internet and modern communication technologies help close the funding gap? If the current statutory limitations on conducting private offerings are eliminated, what are the risks to investors? I look forward to answering any questions you may have regarding each of the bills being considered by the Committee. However, I will limit my remarks to two experiences that may prove instructive in considering crowdfunding legislation, as this legislation has the greatest potential for abuse.

**Lessons Learned From Ace-Net—The Critical Role of Securities Intermediaries**

Attempts at utilizing technology to make processes more efficient, in this case the market for seed and early-stage capital, are not new. In the early 1990s, as the world was for the first time coming online, "disintermediation" was the mantra . . . technology would cut out the middle-man. In the case of the market for early-stage capital, however, it did not.

In 1997, the Small Business Administration's Office of Advocacy, working in consultation with the Securities and Exchange Commission, the North American Securities Administrators Association, and the University of New Hampshire's Whittemore School of Business and Economics, launched the Angel-Capital Electronic Network, more commonly known as "ACE-Net."[4] It was an Internet-based

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ney-Advisor in the Commission's Division of Corporation Finance in Washington, DC. While at the Commission, I was appointed by the United States Attorney's Office to serve as a Special Assistant United States Attorney to prosecute a major criminal securities fraud case that I had litigated for the Commission.

[2] *See, e.g.,* recently released *Fall 2011 State of Small Business Report,* John Paglia, lead researcher of the Pepperdine Private Capital Markets Project and associate professor of finance at Pepperdine University's Graziadio School of Business and Management.

[3] *Private Capital Markets Project Survey Report 2011–2012*, Private Capital Markets Project, Pepperdine University's Graziadio School of Business and Management (*www.bschool.pepperdine.edu/privatecapital*).

[4] ACE-Net received a no-action letter from the staff of the Commission (Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996)), key no-action letter that many have relied on for guidance on the issue of whether organizers of Internet-based matching services are required to register as broker-dealers or investment advisers. In determining that ACE-Net was not required to register, the Commission staff emphasized that ACE-Net and the local operators did not provide advice about the merits of particular investments, did not participate in negotiations for transactions between participants, did not receive compensation from ACE-Net users, other than flat fees to cover administrative costs (which were

Continued

matching service for accredited investors and entrepreneurs seeking up to $1 million in seed funding. The network was to be operated by local nonprofit entities and universities.

Although ACE-Net provided a mechanism through which entrepreneurs could conduct a general solicitation of their offering, ACE-Net was not successful, in part, because sophisticated investors simply did not identify investment candidates by searching companies at random over the ACE-Net portal. Without an active connection between entrepreneurs and the investment community, deals did not get done.

Although, today, many more people are connected through social media, a passive portal, or even several of them, through which an investor may access potentially hundreds of investment opportunities, may not be the catalyst to spur seed-round capital formation. The old adage that securities are sold . . . rarely are they purchased, especially by nonprofessional investors . . . was as true in 1997, as it was in 1933, and as it likely is today.

We learned that more sophisticated individual investors invest when the investment has, in some sense, been validated. Although this validation may come in the form of participation in the offering by recognized investors, most often it is based on a recommendation from a trusted financial advisor.[5]

In the light of this reality, we realized that the active involvement of securities professionals in the capital raising process is critical to capital formation. I believe the challenge in adopting new legislation to stimulate early-stage capital formation is to maintain effective regulation over those professionals, while not imposing too high a regulatory barrier to entry, and to ensure that incentives are not inadvertently created that lead to the formation of unregulated securities markets.

**Lessons Learned From Unregistered Finders—The Potential for Abuse**

Since the enactment of the Securities Act of 1933, the most common exemption from the requirement to register the offer and sale of securities with the Securities and Exchange Commission is the so-called "private offering" exemption found in Section 4(2) of the Act. The hallmark of the private offering is that a general solicitation of securities is prohibited. One method for the issuer to satisfy this requirement is for the issuer to show that it had a preexisting relationship with the investor. Although the staff has stated that this is not exclusive, neither it nor the courts have defined clear boundaries around the general solicitation issue.

However, in recognition of the importance of securities intermediaries to facilitate private offerings, since the 1980s, the Commission staff has made clear through its no-action letters, that issuers may engage a registered broker-dealer as placement agent and, in effect, use the registered broker-dealers' "preexisting relationships" with the broker-dealers' existing customers.

With one exception, this staff position, however, did not extend to preexisting relationships between investors and "finders," who are nonregistered securities intermediaries. The exception was for the unusual facts in the case of the entertainer Paul Anka. Anka, who obtained a commission for providing names of certain of his acquaintances to an issuer, obtained a no-action letter, as he clearly was not in the business of effecting securities transactions, and this was viewed by the staff as a one-time occurrence. Unfortunately, many incorrectly interpreted the Paul Anka no-action letter and relied upon it to create the so-called "finders" exception to the broker-dealer registration requirement.

As a result, in Southern California, as well as in other places around the country, "boiler rooms" emerged . . . a class of unregulated securities salespersons who worked to develop relationships with individuals, many of whom were at home and retired. Although oftentimes the individual solicited appeared on a list of purportedly "prequalified" investors, in most cases investors were solicited by telephonic cold-calls.

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not contingent on the completion of any transactions), did not hold themselves out as providing securities-related services other than operating ACE-Net.

After several years, the Office of Advocacy transferred ACE-Net to a nonprofit organization in an attempt to "privatize" it. My law partner, Lee Petillon, served as counsel *pro bono* to the nonprofit organization, and we worked closely with Terry E. Bibbens, Entrepreneur in Residence in the Office of Advocacy, U.S. Small Business Administration, who was instrumental in ACE-Net's formation and continued to work *pro bono* to create a viable Internet securities intermediary.

[5] Recommendations to purchase securities are, and should, be regulated. The staff of the SEC rejected an ACE-Net proposal to permit it to highlight to potential investors those offerings in which a venture fund or organized Angel group participated. The SEC staff deemed such activity constituted investment advice that was beyond the scope of the staff's no-action letter, in which the staff agreed not to take Enforcement action against ACE-Net for not registering as a broker-dealer.

Eventually, the experienced unlicensed salesperson, indeed, developed "pre-existing" relationships with these investors, as many of the investors serially invested in deals offered by the salesperson. For the unlicensed securities intermediary, this investor pool served as the wellspring for unregistered intermediaries who continued to tap it, and generate hundreds of millions of dollars in commissions, throughout the Internet boom and beyond.[6]

**The Crowdfunding Bills (S. 1791 and S. 1970)**

I fully support the intent behind the crowdfunding bills. However, I share Professor Coffee's concerns that unregistered salespersons may abuse the broker-dealer registration exemption set forth in Section 7 of the bill. Unregistered salespersons of the sort that I described will, with little effort, satisfy the requirements for the exemption in Section 7 of S. 1791.

On the other hand, S. 1970, adopts a regulatory regime for intermediaries that requires them either to elect to register with the Commission as a broker-dealer or as a newly defined "funding portal," subject to several definitional proscriptions.

S. 1970 appropriately limits the scope of permissible activity of a funding portal by prohibiting it from:

- offering investment advice or recommendations;
- soliciting purchases, sales, or offers to buy the securities offered or displayed on its Web site or portal; and
- compensating employees, agents, or other third parties for such solicitation or based on the sale of securities displayed or references on its Web site or portal.

S. 1970 also provides reasonable limits on maximum individual investment limits. By including an aggregate limit applicable to all crowdfunded investments, in addition to dollar investment limits per company, S. 1970 addresses a concern known as "stacking," whereby an individual investor invests in successive offerings but manages to satisfy the requirements of each individual offering.

Finally, the $1 million exemption limit under S. 1970 may be adjusted by the Commission to reflect the annual change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics. If the Commission were permitted by rule to increase the exemption limit, the exemption, if successful for seed offerings up to $1 million, could be scaled to cover an even greater portion of the funding gap.

In summary, S. 1970 balances the need to facilitate access to critical seed capital with important investor safeguards.

[6] Last year, the Commission staff issued a no-action letter, Brumberg, Mackey & Wall, P.L.C. (May 17, 2010), stating that, "A person's receipt of transaction-based compensation in connection with [securities sales] activities is a hallmark of broker-dealer activity."

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

**STATE ENFORCEMENT ACTIONS CONCERNING SECURITIES FRAUD, CAPITAL FORMATION, AND INTERNET OFFERINGS FROM NASSA, SUBMITTED BY CHAIRMAN JACK REED**

December 2011

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

## Enforcement Section

### State Enforcement Actions Concerning Securities Fraud, Capital Formation and Internet Offerings

*State securities regulators brought more than 2,000 enforcement actions in 2009-2010 involving investment fraud, and more than 1,700 cases involving unregistered securities. The fraudulent activity by issuers and promoters in these cases included misstatements, misuse of funds, failure to disclose important facts and the use of false or misleading documents. Fraud and deceit most certainly exist in the arena of capital formation, and legitimate entrepreneurs and small businesses need lawmakers and regulators to keep capital markets clean and credible. The statistics below underscore the unfortunate prevalence of investment fraud across the nation, and the important work of state securities regulators to stop the same and provide relief to investors. Those numbers are followed by summaries of enforcement actions from sixteen states involving fraud or securities violations by purported startup companies, Internet promoters and outright scam artists taking advantage of retail investors.*

### State Securities Regulators Enforcement Activity at a Glance*

| | |
|---|---|
| **Enforcement Actions Initiated** | **2009: 2,294** |
| | **2010: 3,475** |
| **Actions Involving Fraud** | **2009: 983** |
| | **2010: 1,079** |
| **Jail Time Sentenced for Securities Violations** | **2009: 1,786 years** |
| | **2010: 1,134 years** |
| **Investor Restitution Ordered** | **2009: $4.7 billion** |
| | **2010: $14.1 billion** |
| **Fines, Penalties and Payments Ordered** | **2009: $245 million** |
| | **2010: $171 million** |
| **Investigations Launched** | **2009: 7,086 new investigations** |
| | **2010: 7,063 new investigations** |
| For more information on state securities enforcement efforts, visit: http://www.nasaa.org/regulatory-activity/enforcement-legal-activity/enforcement-statistics/ | |

*Source: North American Securities Administrators Association 2010 Enforcement Report

**Illinois: Chris Zander, Zander's Old Town Brewery, Inc., et al. (No. 0900470)**
Order of Prohibition:
http://www.cyberdriveillinois.com/departments/securities/administrative_actions/2010/april/christzander_op.pdf

Illinois securities regulators took action in 2010 to prohibit fraud in the offer of securities when they ordered Chris and Amy Zander to stop selling securities through a third-party website. The Zanders began soliciting investments in their start-up brew pub on a website dedicated to providing a marketplace to buy and sell used brewing equipment, list job openings and list investment opportunities. The Zanders made false claims about their existing capitalization and bank backing to raise $50,000 from an Illinois resident who never received a return or his principal.

**Indiana: State of Indiana v. Wanda Robertson (41D03-0905-FC-00017)**
News release: http://www.in.gov/sos/3557.htm

In Indiana, Wanda Robertson pleaded guilty to three felonies, including securities fraud, when she illegally solicited investors through Craigslist by offering limited partner ownership interests in her company, The Real Estate Paper Chase. The company, using lines of credit obtained in investors' names, was supposed to invest in real estate at the direction of Robertson. Instead, she used the lines of credit for personal expenses and three investors lost approximately $170,000. Robertson was ordered to pay restitution to her victims.

**Kansas: State of Kansas v. Donald G Atteberry (05CR01317)**
News release:
http://www.ksc.ks.gov/archives/39/Donald%20G.%20Atteberry%20Shawnee%20County%20Veterinarian,%20Donald%20Atteberry,%20Guilty%20of%20Securities%20Fraud.pdf

Kansas securities regulators sent Donald G Atteberry to prison for 86 months after he solicited more than $1,300,000.00 from eight Kansas residents for a fictitious cattle embryo transfer program. The investigation into Atteberry, a licensed veterinarian, failed to find any evidence that the embryo transfer program ever existed. Atteberry used short term promissory notes to encourage investors to capitalize his program, and then used those funds as Ponzi payments to other investors and for his own personal expenses. Atteberry pleaded guilty to 36 felony counts of securities violations.

**Kentucky: Justin Thad Tinsley (2008-AH-282)**
News release:
http://kfi.ky.gov/legal/Securities%20Enforcement%20Actions/Justin%20Thad%20Tinsley%20042408.pdf

The Kentucky Department of Financial Institutions entered an order to cease and desist against Justin Tinsley who had solicited investors through Craigslist to invest in his website business. Tinsley initially represented he would pay 35% interest but then later offered to pay 100% interest after his initial solicitation failed to attract any investors. The immediate action of Kentucky securities regulators prevented investor losses.

**Maine: Maine v. Murphy (CR-09-149)**
Indictment: http://www.maine.gov/tools/whatsnew/attach.php?id=75153&an=1

A Maine jury convicted Eric S. Murphy, Jr. in 2010 on four counts, including securities fraud, in connection with an investment scam he ran in conjunction with his residential construction loan business. Murphy, a former mortgage loan broker whose license was revoked by the Maine Bureau of Consumer Credit Protection in April 2009, took approximately $450,000 from 4 investors under false pretenses from October 2006 to April 2008. Instead of using investor proceeds to fund mortgage loans for consumers as promised, Murphy used the bulk of the proceeds for his own business and personal purposes. Murphy was sentenced to 9 years of imprisonment and ordered to pay restitution to his victims in the amount of $358,000.

**Massachusetts: Geoffrey Eiten, et al. (2006-0056)**

Massachusetts regulators are pursuing an action against a Dover man in an alleged $4.5 million "pump and dump" scheme. Geoffery Eiten operated various companies where he acted as a "finder" who brokered securities sales without being properly registered. The Massachusetts Securities Division took action against Eiten's intricate network of entities and straw accounts that used newsletters, articles on investor websites and blast emails to publicly promote certain stocks at the same time he was allegedly selling them for his own account. Eiten allegedly didn't disclose conflicts or his personal trading activities.

**Mississippi: Steadivest Development, et al. (S-09-0187)**
C&D Order:
http://www.sos.ms.gov/links/sec_char/final_orders_and_agreements/securities/Steadivest%20Summary%20Cease%20and%20Desist%20Order%20S-09-0187.pdf

A group of purported real estate and consumer financing companies operating in Mississippi raised more than $1.5 million before it was revealed as a Ponzi scheme and stopped by the Mississippi Secretary of State's office. The 2009 action found that the Steadivest companies' capital drive was plagued by misleading offering documents, commingled investor funds, failure to comply with promised escrow procedures, unavailable financial records, and misuse of investor funds.

**Missouri: Owen Hawkins and Petro America (Missouri AP-08-26)**
DOJ news release: http://www.justice.gov/usao/mow/news2011/hawkins.ind2.html
Missouri final order: http://www.sos.mo.gov/securities/orders/AP-08-26a.asp

Owen Hawkins and several Kansas City-area clergymen who formed a "Ministers Alliance" were indicted in 2011 for their role in a $7.2 million securities fraud that victimized thousands across the United States. Hawkins and his co-conspirators promoted Petro America Corporation through inner-city churches and the Internet, and boasted that it was a $284 billion company with assets in the oil, precious metals, real estate and entertainment sectors. The dubious claims made by Hawkins and other indicted promoters on Petro's website and in emails were the basis of alleged misleading statements and omissions that led to actions by the Missouri Securities Division, the Office of the Kansas Securities Commissioner and the U.S. Department of Justice. Three ministers have pleaded guilty in the matter.

**New Jersey: ForeverGreen Enterprises, Inc. (Summary Order)**
News release: http://www.nj.gov/oag/newsreleases11/pr20111130a.html

A purported alternative energy company operated out of two New Jersey homes was the subject of a $400,000 civil penalty in a November 2011 investor fraud case brought by the New Jersey Bureau of Securities. The firm's founder, Michael D. Kelly sold unregistered securities, made false statements and committed fraud when he raised approximately $576,000 for his purported business of deriving fuel and energy resources from industrial, chemical and medical wastes. The Bureau found that Kelly diverted 55% of investor funds to his personal bank account while promising that his company would go public in the near future and generate high rates of return. In 2009 Kelly offered to repurchase the securities from his investors, but failed to follow through and make the repurchases.

NASAA

**North Carolina: Mobile Billboards of America, Inc. (03-017-CC)**
SEC Information: http://www.sec.gov/divisions/enforce/claims/mobilebillboards.htm

North Carolina securities regulators and the U.S. Securities & Exchange Commission brought actions in a $70 million lease-back scheme sold to over 900 investors nationwide, many of whom were elderly. Investors were sold interests in mobile billboards and suffered substantial losses, while commissions ranging as high as 27% went to insurance agents not licensed to sell securities, or licensed brokers selling away from their firms. Investors were provided false statements about the business, and were told their biggest concern should be how the mail truck was going to deliver their returns. Six individuals were eventually indicted, convicted and sentenced to Federal prison in 2008, and the North Carolina Securities Division issued cease and desist orders against 33 individuals selling the offering.

**Oregon: Kristopher K. Keeney (S-11-0073)**
Final Order: http://www.dfcs.oregon.gov/securities/enf/orders/S-11-0073.pdf

A Portland, Oregon man was fined $345,000 in civil penalties for promoting an online pyramid scheme in August 2011. Kristopher K. Keeney solicited investors for InC, or "I need Cash," through advertisements on various websites. In Keeney's pyramid scheme, investors paid $275 for one spot on a matrix and then were required to recruit others to fill a total of seven spots. Once the matrix was filled, the investor would receive a return of $825, of which $275 was automatically reinvested into a new matrix. Keeney collected at least $95,000 from people throughout the country who wanted to "join" the club and then used participants' funds for his own purposes instead of returning them to investors as promised. The Oregon Department of Consumer and Business Services found that Keeney, who had previously ran afoul of the law in a charities scheme, violated several securities laws, such as selling unregistered securities and making untrue statements that no investor would lose money.

**South Carolina: Marc Hubbard, et al. (File No. 09034)**
C&D Order:
http://www.scag.gov/securities/securitiesorders/marchubbardandsportsdimensions.pdf

The South Carolina Securities Division took enforcement action against the president and CEO of a company "specializing in the concert business" and which sought to raise capital through mailings in South Carolina, Nevada and Arizona. The CEO, Marc Hubbard, also operated a website that provided offering documents which claimed, among other things, that all investor funds, exchanged for "guaranteed" promissory notes, would be used to book major North American tours. The offering documents were riddled with inconsistencies and failed to disclose prior state securities regulators' actions in California, Nevada and North Carolina. Hubbard solicited $1.8 million in investments, but later

defaulted on the notes, declared bankruptcy, and had $750,000 in federal tax liens filed against his company.

**Texas: Warr Investment Group, LLC, et al. (ENF-10-CDO-1693)**

News release: http://www.ssb.state.tx.us/News/Press_Release/01-07-11_press.php

A Texas judge issued a January 2011 Temporary Restraining Order against Austin-based firms that allegedly sold illegal investments in violation of a Cease and Desist Order issued by the Texas State Securities Board. The actions alleged that the Warr companies and CEO Jim Warr defrauded the public through illegal and deceptive sales of unregistered securities in real estate investment programs. Using virtually every type of Internet advertising available, including maintenance of several websites, carrying advertisements for the investments on Craigslist, offering free eBooks to potential investors, hosting webinars, and soliciting employees online, Warr allegedly guaranteed 8% annual returns and that the real estate investments were safe and secure. The suit alleges that Warr misused and misapplied investor funds to pay commissions to unregistered sales agents and to pay for a 2008 Mercedes Benz and other items unrelated to the investment program.

**Utah: Michael Fitzgerald (SD-05-0010)**

Consent Order (Fitzgerald): http://securities.utah.gov/dockets/05001001.pdf
Consent Order (Rawlinson): http://www.securities.utah.gov/dockets/07008301.pdf

Utah officials brought multiple actions involving the securities fraud perpetrated by Michael Fitzgerald, who was ultimately ordered to pay $20 million in restitution for a real estate fraud scheme that victimized nearly 300 investors. Fitzgerald employed about a dozen unlicensed agents who sold promissory notes to fund California real estate developments while using misleading statements and omitting key facts. Utah securities regulators brought actions against several of the salesmen, including Douglas Rawlinson, Fitzgerald's bookkeeper who also sold his securities and was fined and ordered to pay restitution.

**Virginia: Julius Everett "Bud" Johnson (SEC-2009-00075)**

DOJ News Release:
http://www.justice.gov/usao/vae/news/2011/07/20110719BudJohnsonnr.html

In 2011, the Virginia State Corporation Commission entered judgments against Julius Everett "Bud" Johnson and companies he controlled for fraudulently raising over $11 million for investment capital for start-ups and on-going enterprises from 160 investors primarily in Virginia and North Carolina. Johnson owned at least ten businesses and told investors that their funds would be used to directly capitalize specific companies, which would generate the promised returns on investment. Instead, a significant portion of the invested funds was used to repay other investors and to cover operating costs for unrelated businesses. In April 2011, Johnson pleaded guilty and was sentenced in July to 97 months in prison.

**Washington: Michael D. Sellers, et al. (S-11-0578-11-FO01); and Columbia City Cinema, Inc., et al. (S-10-424-11-FO01)**
Final Order (Sellers): http://dfi.wa.gov/sd/orders/s-11-0578-11-fo01.pdf
Final Order (Columbia City Cinemas): http://dfi.wa.gov/sd/orders/s-10-424-11-fo01.pdf

On October 6, 2011, the Washington Securities Division entered a Final Order against Michael D. Sellers, Robert Keskemety and companies they controlled for raising at least $87,250 from Washington residents through the sale of unregistered interests in film production and distribution companies. Sellers and Keskemety were also charged with violating Washington's anti-fraud laws.

In a similar case, on August 22, 2011, the Washington Securities Division entered a Final Order against Columbia City Cinema, Inc. and Paul Doyle for making securities offerings that were incomplete and contained statements which were false or misleading. Columbia City Cinema operated a 3-screen neighborhood cinema showing first-run movies in Seattle, but in offering securities on its website and through the media, failed to adequately describe the risks involved in investing in the company.

**STATEMENT SUBMITTED BY JEFF LYNN, CHIEF EXECUTIVE OFFICER, SEEDRS**

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December 13, 2011

Via E-mail

Senator Jack Reed, Chairman
Senator Mike Crapo, Ranking Member
Subcommittee on Securities, Insurance and Investment
U.S. Senate Committee on Banking, Housing & Urban Affairs
728 Hart Senate Office Building
United States Senate
Washington, D.C. 20510
United States of America

Re: Hearing on "Examining Investor Risks in Capital Raising"

Dear Chairman Reed and Ranking Member Crapo:

I am honored to make this submission in connection with tomorrow's hearing on "Examining Investor Risks in Capital Raising", and I wish for it to be included as part of the hearing's record. This submission relates in particular to crowdfunding, which is the subject of at least two bills currently before the Senate Banking Committee (S. 1791 and S. 1970).

Background

I am the Chief Executive Officer and a co-founder of Seedrs, a forthcoming equity crowdfunding platform based in London.

My background is as a U.S. securities and corporate lawyer. I received my J.D. from the University of Virginia School of Law, I am a member of the New York Bar, and I practiced with the international law firm of Sullivan & Cromwell LLP from 2004 to 2008 in New York and London. During my time at Sullivan & Cromwell, I represented industrial, financial services and private equity firms on a range of securities, finance, corporate and governance matters. I also worked closely with the SEC and Britain's Financial Services Authority (FSA) on a range of matters, and I oversaw the periodic editing and updating process for The Sarbanes-Oxley Deskbook by Jack Bostelman.

I left the active practice of law in 2008 in order to pursue a career working with early-stage businesses, which I firmly believe will be the greatest source of wealth and job creation, as well

as innovation, in the years to come. As part of my career transition, I enrolled in the MBA program at Saïd Business School at the University of Oxford, where I met my co-founder, Carlos Silva, and began working on what has become Seedrs.

Seedrs is an equity crowdfunding platform that will allow entrepreneurs to raise up to £100,000 in equity capital from friends, family, community members and the "crowds". In short, the Seedrs process operates as follows:

- Entrepreneurs disclose information about their businesses, which we review and approve, as well as the amount of money the businesses are seeking to raise in exchange for how much equity, all via our website.

- Investors review businesses' information, decide which ones they want to invest in and how much, and purchase equity interests in the businesses they choose by transferring funds and signing electronic documentation, all via our website.

- We aggregate multiple small investments in each business into one large one, and once a business has received the full amount it is seeking, conduct legal due diligence and execute the share purchase through a special-purpose vehicle.

- Entrepreneurs access a powerful network of mentors and other support once they've been funded, all while limiting their administrative burdens by allowing them to interact with only one legal shareholder.

- Investors stay informed about and involved in the businesses as they develop following investment, and they receive payment of dividends and proceeds from sale.

Seedrs has applied for authorisation by the FSA, which is a necessary precursor to launching the platform. We hope to be authorised within the next few months, and assuming that we are, we plan to launch the platform in the UK in early- to mid-2012, with the aim of rolling out through the rest of the European Union in 2013. We are backed by a group of angel investors from both Britain and the United States.

In September I testified before a subcommittee of the House Committee on Oversight & Government Reform to share insights from our experiences in building Seedrs, and in particular the lessons we have learned in designing a platform that is economically viable while maintaining the highest levels of protection for investors. I'd like to use this submission to share some of these insights with you and the other honorable members of this Subcommittee.

Summary

Equity crowdfunding has tremendous potential to help entrepreneurs build great businesses, create vast numbers of new jobs and provide a substantial boost to the economy. However, this form of finance needs to be implemented very carefully in order to ensure that investors are protected and, concomitantly, that the integrity of the market is maintained. If investors fail to be treated fairly when investing through crowdfunding platforms, they will avoid investing at all, and the potential value of equity crowdfunding will fail to be realized.

The current legislative proposals to permit equity crowdfunding in the United States, while a good start, do not go far enough to protect investors and the market. Both H.R. 2930 (which was passed by the House six weeks ago) and S. 1791 address key disclosure issues but, in exempting platforms from regulation and having no regard for the structuring and post-investment processes, they fail to reflect important realities of how equity crowdfunding works—and needs

to work—in practice. S. 1970 appears to represent an improvement with respect to the regulation issue, but there are still important concerns on how investments are completed and then handled following completion.

Set forth below is a detailed explanation of where I believe S. 1791 and H.R. 2930 fall short—as well as the outstanding issue in S. 1970—and what needs to be in place for an equity crowdfunding regime to function properly.

Lack of Regulation of Platforms

S. 1791, like H.R. 2930, specifically exempts equity crowdfunding platforms from broker-dealer requirements. The desire not to impose substantial compliance costs on platforms that are facilitating such small transactions is a sensible one, but I think the absence of any form of regulatory supervision at all is dangerous for two reasons.

First, it will invite a lot of fly-by-night operations into the market, and even if they are not behaving in a fraudulent way, their lack of systems and controls will mean that money gets misplaced and transactions fall apart. This, in turn, will lead to the whole crowdfunding space appearing amateurish and a general loss of confidence in the market. I would note that the main area of focus in the FSA's review of Seedrs has been on our systems and controls (as it would be for any FSA applicant)—rather than the substance of the business—because they appreciate that if core operations were not up to appropriate standards, the risk to investors and the market in general is potentially massive. I think that similar concerns would apply in the United States, and that some form of oversight by the SEC or by FINRA could help alleviate them.

Conversely, a lack of regulatory approval makes it more difficult for those platforms that do have strong systems and controls to stand out and attract investors. We hear repeatedly from potential Seedrs users that the fact that we will be FSA-authorised prior to launch is critical to their decision to use us; meanwhile, the several UK and European platforms that have structured themselves so as to avoid regulation have struggled to persuade the market that they are legitimate operations. For crowdfunding to be an effective source of capital for entrepreneurs, it will be important that people actually start investing through the well-run platforms, and in the absence of any form of regulation, many investors will be significantly more hesitant to do so.

If lawmakers are serious about equity crowdfunding becoming a viable method of capital-raising for new businesses—and therefore job creation for the economy—some sort of supervision is absolutely essential. While I do not have a view on exactly what the regulatory framework should look like, I am encouraged by the concept of a "funding portal" introduced by S. 1970. Based on our experiences in Britain, I am confident that it is possible to design a form of registration and supervision that results in crowdfunding platforms being monitored effectively while not facing undue compliance burdens. A new, lighter-touch version of broker-dealer registration—which is what the funding portal concept appears to be aiming at—has the potential to strike this balance.

Lack of Structuring and Post-Investment Requirements for Platforms

The other key concern relates to crowdfunding platforms' roles in structuring investments and managing them post-completion. Neither S. 1791, S. 1970 nor H.R. 2930 address this issue, and I think it is probably the most important consideration in adopting a crowdfunding regime. The issue is a slightly complex one, so for ease of reading I have broken this section into several parts.

*Investing in the Shares of Small, Private Businesses*

As a threshold point, the equity of startups and other small businesses is a strange beast. Economically it tends to be very straightforward—returns are broadly binary, liability is limited to purchase price and value is generally driven by the company's core performance rather than the vagaries of speculation or complex mathematics—which is a large part of the reason why it is sensible to allow ordinary investors to allocate their capital to it. Legally, however, it can be very complicated (and is very different from purchasing shares of a publicly-traded company): the failure to structure an investment properly, and then to take appropriate shareholder actions post-investment, can mean that investors never manage to realise the value that the equity should have had.

To give just three examples of the many types of legal issues that arise:

1. *What if the company in which the investment is made is not actually the legal entity that controls the business and its key assets?* For example, the founders may have developed the intellectual property before the company was incorporated and then failed to assign it to the company, meaning that they retain a personal claim on it. Or, in a more dishonest case, the founders could just set up a shell company to receive the investment while actively conducting business through another company.

2. *How do you ensure that investors are getting the amount of equity they have expected?* On Seedrs, and presumably most future equity crowdfunding platforms, the business declares how much capital it is seeking and what percentage of its equity it is offering (or, conceivably, there is an open-price auction process that fixes the percentage of equity). When the company issues its shares to the investors, someone needs to make sure that the number of shares issued relative to the number of shares outstanding reflects the agreed percentage: if the company says it is offering 10% of its equity and issues 100 shares on the basis that 1,000 are outstanding, but actually the founders and their friends have previously been issued 1,000,000 shares, that is a serious problem for the new investors.

3. *Following completion of the investment, what happens when individual shareholder action is required?* In publicly-traded (and larger private) companies, this does not come up because all corporate actions are authorised either by the board or by a shareholder vote, but in early-stage companies there are times when the signature or approval of every shareholder is required, and the failure to take that action would have a prejudicial effect on the company. This issue arises most often where a later-stage investor conditions its investment on the modification of certain terms of previous investors' agreements: if one shareholder fails to sign—even if only because he or she could not be tracked down or failed to act quickly enough—the subsequent financing might fall apart, which could in turn hurt the long-term value of the investors' shares.

These are the sorts of issues that venture capitalists, angels and other early-stage investors address through a combination of legal due diligence, provisions in the subscription agreement and monitoring and enforcing rights post-investment.

*What This Means for Crowdfunding*

By its nature, crowdfunding is intended to be an exercise in mass participation, with no one central investor—like a venture capitalist or angel—pulling all the strings. That's great for the process of making investment decisions, as the wisdom of the crowds is likely to make better choices than a few professional investors. But when it comes to the details of structuring a legal transaction or enforcing shareholder rights, the crowds are much less likely to be able to act

effectively. Due diligence will not be performed, appropriate terms will not be included in the subscription agreement, and no one will be in charge of monitoring the investment after it is completed.

This will be a problem when it causes an investee company to fail (such as because consents could not be gathered to complete a subsequent round of financing), but the risk to investors is actually much more substantial if the startup *succeeds.* Everyone knows that many businesses will not work out and therefore not return investors' capital, but if the business succeeds and investors do not participate in that success because of a lapse in structuring or management, that will be a very serious problem for the market. We have seen the bitterness of the litigation between the Winklevoss brothers and Facebook, and that was a case where the plaintiffs did not even think they had made a formal investment (just that they had contributed informal IP). One can only imagine what will happen if the "next Facebook" gets its initial funding through a crowdfunding platform but the investors fail to benefit.

It is this "success risk"—the risk that a startup becomes hugely successful, but due to lack of proper due diligence, structuring or enforcement the crowdfunding investors fail to participate in the success—that has the potential to cause the most harm to investors. There has been much discussion in connection with the current legislative proposals around how much investors should be allowed to invest: S. 1791 set a lower cap than H.R. 2930, and S. 1970 has a lower cap still (except for wealthier investors). But the amount of the cap, wherever it is set, will pale in comparison to the amount lost by an investor if a business succeeds but the investment was improperly structured or failed to be monitored. If success risk materialized, the loss to any given investor is almost unlimited and could easily run into millions of dollars.

*The Role of the Platform*

There seems to have been an assumption by many of the participants in this debate that the existing non-equity crowdfunding platforms, such as Kickstarter and IndieGoGo, should provide the model for equity crowdfunding. On these platforms, people raising money promise non-monetary "rewards"—such as a souvenir poster or film credit—to their backers, and it is the recipients of funding who are responsible for delivering those rewards without any involvement from the platform. It appears that some people think that equity crowdfunding will work the same way—startups will just put share certificates in the mail after receiving the money—and that the platform would have a similarly hands-off role.

Given the issues discussed above (and the fact that they do not apply in the context of posters or film credits), this assumption is a very problematic one. For equity crowdfunding to work, there needs to be some central party performing due diligence, structuring the transaction and monitoring and enforcing shareholder rights post-completion, and the only clear candidate for that role is the crowdfunding platform itself. This is the role that Seedrs will play, and it's the role that any other platform needs to play if the investors who use it are to be protected. The platform need not take nearly as hand-on a role as a venture capitalist might—there is no need for it to take a board seat, conduct technical due diligence or be involved in the investment decision—but the core "mechanical" aspects of making and managing the investment must be part of the platform's job.

*Implications for Current Legislative Proposals*

S. 1791, S. 1970 and H.R. 2930 pose two problems with respect to these issues. First, none of them require crowdfunding platforms to take any sort of role in making and managing the investment. Perhaps part of becoming a funding portal, as proposed by S. 1970, would involve taking on these responsibilities, but it seems to me worthwhile to enshrine that crucial aspect of

a crowdfunding platform's job in legislation. S. 1791 and H.R. 2930, meanwhile, appear not even to open the door to requiring this sort of action by the platform.

The second problem is the bigger one: not only do these legislative proposals not require the platform to be involved in due diligence, structuring or post-investment management, but their effect may even be to prohibit it—or at least the post-investment components of it. The main way in which a crowdfunding platform would be able to manage an investment post-completion would be to hold the shares of the startup on the underlying investors' behalf, either through a special-purpose vehicle (SPV) or through a nominee structure. These passthrough arrangements are very straightforward mechanisms for allowing investors to have full economic interest in their investment while one manager is able to take action on their behalf. However, under the Investment Company Act of 1940 (the "1940 Act"), it is highly likely that these arrangements could be deemed "investment companies", a broadly-defined term that covers a wide range of collective investment arrangements. If this definition applied, an extensive regulatory regime would apply, and the practical effect would be to prevent platforms from acting on behalf of investors once the investment has been made.

There are therefore two sets of changes that, in my view, need to be made to current proposals in order to ensure that crowdfunding investors are protected from success risk. First, some level of intermediation by the crowdfunding platform should be mandated. And second, the 1940 Act should be amended in order to exempt nominee and SPV arrangements that crowdfunding platforms would use in order to manage investments following completion.

Conclusion

It is very encouraging that Congress is looking to tackle the important challenges of capital raising by early-stage businesses. While this is an area of the capital markets that tends to be off of many people's radars, it is crucial to the economy that more job- and value-creating businesses find the initial capital they need to get off the ground. I have long been a believer that equity crowdfunding has an important role to play, and that at the same time it provides a valuable opportunity to investors. However, it is vital that the legal and regulatory system around equity crowdfunding be the right one, and that while it not be so burdensome as to make crowdfunding economically impracticable, sufficient oversight and investor protections are maintained for the sake of the integrity and success of the whole market.

I hope you find the foregoing useful. I would be very happy to clarify or amplify any of these comments at any time.

Yours sincerely,

Jeff Lynn