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SPURRING JOB GROWTH THROUGH CAPITAL FORMATION WHILE PROTECTING INVESTORS–PART I

HEARING

BEFORE THE

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

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING JOB GROWTH THROUGH CAPITAL FORMATION

DECEMBER 1, 2011

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SPURRING JOB GROWTH THROUGH CAPITAL FORMATION WHILE PROTECTING INVESTORS–PART I

THURSDAY, DECEMBER 1, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good morning. I would like to call this hearing to order.

Our Nation is facing an unemployment crisis. Nearly 14 million Americans are unable to find a job, and over 5 million have been unemployed for 6 months or longer. Here in Congress, putting our fellow Americans back to work should be, and must be, our top priority.

The American people are frustrated, and rightfully so, by a political system that is bogged down in partisan battles. However, our focus today is an issue where I believe there is real potential for bipartisan cooperation and for results.

We are here to discuss how to help startups and businesses get access to the capital they need to grow and to create new jobs, while protecting investors.

Today the Committee is pleased to hear testimony from three of our fellow Senators as well as expert witnesses who will talk about challenges that businesses and entrepreneurs can face when attempting to raise money by selling stock.

The Committee will also hear about proposals and ideas that seek to improve existing securities laws. The witnesses will discuss the SEC's requirements for a person or company to sell securities to the public.

They will also provide insights on proposals to expand the scope of Regulation A offerings, to permit general solicitation of investors in Regulation D offerings, and to allow individuals to solicit and sell small amounts of stock over the Internet through crowdfunding.

They will address the size of a private offering and the amount of money that a crowdfunder should be able to risk without full regulatory protection. They will discuss the types of markets where these securities should trade. They will also describe the existing

investors' safeguards, such as disclosures about the business and financials, and how current proposals would affect those safeguards.

In addition, witnesses will review the requirements for banks and other companies with 500 or more shareholders of record to register with the SEC, which requires important information to be provided regularly to shareholders, and discuss whether the transparency is important to investors and appropriate for different types and sizes of companies.

And additional ideas may be raised in the Committee's discussions. A recommendation that came up in a recent hearing, and which I have a strong interest in exploring, involves amending Regulation D to add American Indian tribes to the list of accredited investors.

I want to thank Senator Shelby and his staff for their cooperation in developing this hearing. I think we agree that firms that are in a position to grow will seek to raise more capital if the process of selling stock is made easier and less costly. If they succeed, this can lead to more jobs and economic prosperity. At the same time, investors must be willing to buy the stock that businesses offer, and they are more likely to do so when they have enough reliable information and know that they are not at risk of being scammed.

I look forward to the testimony of the witnesses and to working with my colleagues on both sides of the aisle to develop bipartisan legislative solutions that promote job growth and business expansion while protecting investors.

With that, I will turn to Senator Shelby for his opening statement.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you for calling this hearing.

Today the Committee will consider ways to increase job growth by improving access to capital for small businesses. Over the past 3 years, the number of new businesses launched each year has fallen by 23 percent. This sharp decline should be viewed as a warning signal about our economic future. Small businesses, as we all know, are the lifeblood of the U.S. economy. If entrepreneurs are not creating new small businesses today, there will not be new large industries tomorrow.

It is, therefore, critical to the long-term health of our economy that entrepreneurs have the tools they need to create and to innovate. Unfortunately, the laws and regulations pushed by the administration over the past 3 years have created a regulatory climate hostile to business creation. The administration has viewed businesses not as valuable contributors to our economy, but as a means for implementing social policy.

In the 2,000 pages of Dodd-Frank, there is not a single item that would make it easier to start a business. Instead of focusing on how to create jobs, the administration has imposed one costly mandate after another. These mandates are not only costly, but they bog down small businesses with unnecessary regulations. In some cases, these regulations are fatal to fragile startups. In other cases,

they discourage the flow of capital investment needed to even start a new business.

It should, therefore, be no surprise that our unemployment rate has stagnated at 9 percent and business creation has plummeted over the past 3 years. If we want to return to an economy that creates jobs, there needs to be a change in policy. Fortunately, there seems to be one area where there is a bipartisan consensus for change: making it easier for entrepreneurs to obtain funding. This could be done in two ways:

First, the securities laws and regulations could be amended to make it easier for private companies to raise capital. For example, companies could be permitted to raise money from a greater number of investors without having to incur the substantial reporting costs of registering with the SEC. And since nearly all businesses are private companies, these types of reforms could help reduce one of the primary obstacles all entrepreneurs face.

The second way we can increase the availability of funding is to make it easier for companies to access the public markets. Presently, small businesses that want to go public have to overcome a one-size-fits-all regulatory approach that requires them to bear disproportionate costs.

According to a recent report by the IPO Task Force, a group of professionals representing emerging growth companies, and I quote: "The cumulative effect of a sequence of regulatory actions, while mostly aimed at protecting investors from behaviors and risks posed by the largest public companies, have driven up costs for emerging growth companies looking to go public."

The IPO Task Force estimates that the average cost for a company to go public is $2.5 million, and the annual cost to stay public is $1.5 million. These costs make the public markets unaffordable for thousands of small companies. Regulation can deprive funding for companies at exactly the moment they want to expand and to create new jobs.

And while our securities laws have helped to preserve our capital markets as the largest and the deepest in the world, they need to strike the right balance between protecting investors and ensuring that companies can raise funds. I think it is becoming apparent that we do not have the right balance. The laws need to consider the real-world costs of complying with regulations, especially those borne by small businesses.

Accordingly, I am encouraged that several bills have already been introduced with bipartisan support that would address some of the unique problems faced by small businesses. It is my hope that the Committee will take a serious look at these bills and other proposals to modernize our securities laws.

Over the past few weeks, there has been a lot of talk about the need to do more to create jobs. I believe that these bills give the Committee an opportunity to take action. I stand ready to work with the Chairman on these promising bills.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Shelby.

Are there any other members who wish to make a brief opening statement? Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. I want to commend you and the Ranking Member for holding this hearing. It is a very important topic. We all want to make sure that cutting-edge American businesses have the capital to fund new products and, very importantly, provide jobs.

At the same time, we need to ensure that investors have accurate information to make sound investment choices. Eroding investor protections can have a deleterious effect on investor confidence and actually, and ironically, reduce investment in our capital markets. And I know that our colleagues who are proposing this legislation are attempting to balance the ease of access to the markets along with protections of investors, and I appreciate that very much.

In 1913, Louis Brandeis wrote about the importance of disclosure in securities offerings, that "To be effective," in his words, "knowledge of the facts must be actually brought home to the investor, and this can best be done by requiring the facts to be stated in good, large type in every notice, circular, letter, and advertisement inviting the investor to purchase. Compliance with this requirement should also be obligatory, and not something which the investor could waive." I think that is pretty sound advice even today.

In 1933, Congress adopted the framework. It was not adopted in the last several years, but in 1933, Congress adopted the framework. The Securities Act had a simple goal: for insurers to tell the truth about their offerings. In fact, the small-insurer exemption from registration was limited to an aggregation of about $100,000, which would be $3 million today—in fact, much smaller than it is actually today.

There are various legislative proposals before us that seek to improve the flow of capital between companies and investors. We must carefully consider how the American economy has changed and how both the needs of issuers and investors have changed. Is the process too complex? Do certain longstanding regulatory requirements remain relevant? Or has the economy passed them by? Do the proposed changes increase the risk of fraud? And these are the serious questions that the sponsors have posed in their legislation.

I am interested, obviously, in learning more about the current status of capital-raising efforts, how they can be improved, and I look forward to the testimony of all our witnesses, and I want to again commend my colleagues for their efforts.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you all.

I would like to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Before we hear from our witnesses, three of our colleagues in the Senate are here to provide their thoughts and views on today's topic. Today we will hear from our former colleague on the Committee, Senator Kay Bailey Hutchison of Texas, as well as Senators Mark Pryor of Arkansas and Scott Brown of Massachusetts. Thanks to all three of you for taking the time to be here.

Senator Hutchison, welcome back to the Committee. Please begin.

STATEMENT OF KAY BAILEY HUTCHISON, U.S. SENATOR FROM THE STATE OF TEXAS

Senator HUTCHISON. Well, thank you so much, Mr. Chairman. I want to say right off the bat that I actually wanted to stay on the Committee, but too many Republicans wanted to be on it, and I did not get a chance to do that. I really enjoyed it. I thought it was interesting, and I miss being on it. So I thank you, Mr. Chairman, Senator Shelby, Senator Toomey. I do so hope that we will be able to get an approval from the Committee for us to go forward on the bill that I am cosponsoring with Senator Pryor.

Senate bill 556 is a common-sense bill with strong bipartisan support that will enable growth in our Nation's economy while strengthening our community banking system. Our bill would foster capital formation in the community banking industry and would allow community banks to bolster their balance sheets to meet the more stringent capital standards imposed by the Dodd-Frank Act.

Senate bill 556 would update the threshold before a bank must register its securities with the SEC. Under current law, any company with $10 million in assets and 500 shareholders is required to register its securities with the SEC. The additional capital that would be gotten from our bill would free community banks to lend to creditworthy small businesses who in turn can go out and do what we need them to do: invest in new operations, projects, create jobs, and give our Nation's economy the lift we know it needs.

The asset size threshold, which is $10 million now, has twice been increased since 1964. The 500-shareholder threshold has never been changed. For banks that exceed the 500-shareholder threshold, the high cost of complying with SEC reporting requirements consumes capital resources that could otherwise be used for lending. Community banks tell me they could each save an average of $250,000 in costs to satisfy regulatory requirements if the shareholder threshold is raised to 2,000.

Spread across the entire country, our bill would save community banks more than $80 million, which, when deployed as capital, could allow these banks to lend up to $800 million to America's small businesses.

Community banks and small businesses are the backbone of our economy. With just 11 percent of the banking assets in America, community banks make up 40 percent of all loans to small businesses.

I welcome today's hearing and hope that we will be able to move this bill expeditiously. The House recently passed a companion bill by a vote of 420–2. I am confident that the Senate would pass it by about the same margins.

I want to ask your consent to put two letters that are in support of our bill from the American Bankers Association along with its members, the State associations, and the Independent Community Bankers of America.

Chairman JOHNSON. Without objection.

Senator HUTCHISON. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Hutchison.

Senator Pryor, please proceed.

STATEMENT OF MARK L. PRYOR, U.S. SENATOR FROM THE STATE OF ARKANSAS

Senator PRYOR. Thank you, Mr. Chairman, and I thank all the Committee for inviting me here today to discuss S. 556, a bill to amend the securities laws to establish a higher shareholder threshold for registration of banks as public companies. I want to thank Senator Hutchison for her leadership and for her important efforts on this bill. This is a good bipartisan bill, and we hope that we can move this relatively quickly through the Senate, if possible.

Currently, the Securities and Exchange Commission requires a company with $10 million in assets and 500 shareholders to register its securities with the SEC and comply with the SEC's registration and reporting requirements. Since 1964, the original $1 million asset standard has been increased tenfold while the 500 shareholders of record requirement has never been updated.

I want to emphasize that our bill only changes the shareholder threshold for banks and not for other businesses. Banks are unique businesses in the sense that they are already highly regulated and have to maintain large dollar assets tied to their loans. Consequently, shareholder size is the only meaningful standard for whether a bank should be registered as a public company.

I have spoken with many community banks in Arkansas who are struggling to raise capital or expand their investor base. These community banks are increasingly subject to higher capital requirements due to Dodd-Frank, Basel III rules, and banking regulator stress tests. Increasing their capital reserves will enable these banks to continue to serve and benefit their communities. Increasing the shareholder limit would create an opportunity for community banks to bring in much needed new capital and increase lending. One dollar's worth of capital supports up to $10 in loans. As banks approach the current shareholder threshold, they have to decide whether to go public or to limit their access to capital. The result is that these banks are forced to make fewer loans in order to maintain their capital-to-asset ratio.

Today a community bank with a small investor base is significantly different from what it was 40 years ago. While the shareholder threshold of 500 at one time may have been an accurate reflection of a public market, it is no longer so today. It is time Congress updated the standards for banks.

Thank you again for this opportunity and letting me present the bill, and, again, I want to tell Senator Hutchison how much I appreciate her help on this effort, and

I look forward to working with this Committee on its passage.

Thank you.

Chairman JOHNSON. Thank you, Senator Pryor.

Senator Brown, please proceed.

STATEMENT OF SCOTT P. BROWN, U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator BROWN. Thank you, Mr. Chairman, for calling this hearing. As you know, you and Ranking Member Shelby are embarking

on a discussion of critical importance to our Nation's economy. It is a discussion with need to have as to how we get Americans back to work, and it starts really with capital formation.

It is funny. As I go around the Commonwealth of Massachusetts and visit businesses, I had the opportunity to go to the Cambridge Innovation Center, which has hundreds of businesses, startup businesses, under one roof. And the biggest challenge that they had and have are the lack of regulatory intact certainty, but more importantly, the lack of the ability to actually get capital. And that is one of the biggest challenges, whether you are creating the seed money for a coffee shop, a florist needs capital to buy a truck, tech entrepreneurs with great ideas need capital to file patent applications, investments power payrolls across our Nation in every sector, as we know. It is the grease that keeps the gears in the American economy turning.

But lately, as was just referenced in the proposal that my two colleagues made, capital has been scarce for American entrepreneurs. We all know it. And, predictably, our economy has ground to a near halt in certain respects. Every economist would tell you that many entrepreneurs are looking to the banks, but they know that there is really no money to be had for a lot of these startup businesses, and that, as you know, Mr. Chairman and Ranking Member and members of the Committee, needs to change if we are going to get our economy moving again. So with that change, we need to change some of the rules and regulations that are prohibiting those types of opportunities.

Now, the bill that I am proposing is a bill that was similarly passed—and get ready for these numbers—405 Members of the House—when is the last time you heard that? Last week they did it with the 3-percent withholding, which I sponsored in the Hire a Hero Veterans. Well, this is another opportunity where they saw a need and worked together in a clearly bipartisan manner to create opportunities for small businesses.

Now, the difference between that bill and my bill, because there were some concerns about the threshold in terms of the money that was allowed to be invested in some of the consumer protection—really the rules and regulations that would basically protect people's dollars. I think, quite frankly, my bill is better. It lowers the threshold to $1,000. It offers more consumer protections. So I am bringing this bill forward. It is called "crowdfunding," and that is what happens when many investors make small investments, up to $1,000, in a project or a company. And someone with a business idea—and we all know, gosh, Twitter and Google and Facebook and a lot of those opportunities, those smaller—they started with an idea, and someone with a business idea gets a chance to convince members, his friends, other folks in the social network to join in, and the public at large, asking, hey, let us take a risk together, let us do it together and make that investment. And in return, the investor gets a share of the project or the company.

You know, it is an innovative way, a way to look outside the box and kind of get up with the times to open up the capital markets to the new businesses and existing small businesses. It has the potential to be a powerful new venture capital model for, as I said, instances like Facebook and Twitter age opportunities, and its po-

tential to, quite frankly, create jobs is enormous. But believe it or not, it is currently illegal in the United States because of obsolete regulations, some dating back to the 1930s.

Imagine that the next Steve Jobs is being held back by rules written during the age of the typewriter. I do not even know if people use them anymore. I think I have one tucked under the desk back home.

But, Mr. Chairman, many of these rules were put in place for a good reason back then, an absolutely good reason, but the nature of the business has changed, as we all know, and we should be willing to make thoughtful and careful changes as well because, you know, if not now, when. When are we going to give the tools and resources to our innovative job creators?

Massachusetts is an innovative State. We have a different type of business model back home, and this would just take the gloves off and let the small business movers and shakers really go and do some good work. So I have introduced S. 1792, the Democratizing Access to Capital Act, which would exempt small investments, $1,000 per investment, with a total size of stock offerings capped at $1 million from prohibitive and basically onerous Federal regulations, which is really one of the biggest prohibitors for businesses to actually move forward and take these steps. And because we all know that you need a trustworthy market system before people will invest, my bill provides strong investor protections, as I referenced earlier. And I know that other efforts have been made to set up different caps, some lower, some higher. And I believe my bill is a good place to start in giving a fair shake to all market participants.

I would suggest that you move my bill along with the other bills forward. Let us put them together. I am happy to work with your offices and your staffs to come up with a plan that we can pass in a bipartisan, bicameral manner that the President will sign, because that is the only way we are going to get things done here.

But I am not the only one, as I said, who is moving forward. Even the Administration, entrepreneur groups, the Chamber of Commerce, hundreds of Democrats and Republicans in the House, as I referenced, and many of our colleagues in this distinguished body have made suggestions to legalize crowdfunding.

So the opportunity for a new avenue of capital investment in small business is exciting. It is really kind of new and creative. It is a different way to look at investing, and we should take advantage of this multi- billion-dollar market opportunity to create jobs and get the economic engine going, get our economy moving again and let the small job creators be the ones that kind of help us out of the mess that we're in, and to achieve this promise for entrepreneurs, there must be sufficient confidence in the investors that they are going to get a fair shake, that they are not going to be held back by the burdensome regulation, the onerous reporting requirements. And that is why I have gone further than the House legislation in incorporating investor protections that are necessary to build the market while eliminating outdated and, quite frankly, costly regulations. And it limits the risk, as I said, $1,000 per person, and if you actually take it up, for some people that is a year's cost of entertainment for some. Do you think maybe if they had a choice between spending that money on entertainment and actually

taking a chance on the next great business opportunity with a potential for a good return that they would not want to take advantage of that opportunity? I know I would, and many of our other friends back home would like to do that.

It also includes investor rights and protections and enhanced oversight. It also includes a role for States in providing oversight. I have spoken to the Secretary of State back home.

I do want to acknowledge Senator Hutchison's and Senator Toomey's respective bills. They are thinking outside the box, again, in bringing new opportunities to our body here so we can try to get us back on track. And they are also seeking to eliminate the onerous SEC reporting regs for small business, including community banks, as was just referenced. I support their efforts as well, because it allows small businesses and community banks to focus their attention where it should be: in customer lending, in job creating, and giving the tools and resources to the men and women of my State and this great country the opportunity to do it better and be better and provide for their families and create jobs.

So I hope we can hear today about all the ways that capital formation can be fostered. Enough of the excuses. Enough of the control that everyone is trying to get over these things. We need to do it better. We have an opportunity to do just that, and I commend you and the Ranking Member for holding this hearing, and my colleagues for participating as well.

Thank you.

Chairman JOHNSON. Thank you, Senators. You may be excused.

As we wait for our witnesses to take their seats, I would like to briefly introduce the witnesses that are here with us today.

Ms. Meredith Cross is the Director of the Division of Corporation Finance at the Securities and Exchange Commission.

Mr. Jack Herstein is the president of the North American Securities Administrators Association.

Professor John C. Coffee is the Adolf A. Berle Professor of Law at Columbia University Law School. He has testified many times before this Committee during the past decade.

Mr. Chris Gheysens is executive vice president and chief financial officer of Wawa, Incorporated.

Mr. Scott Cutler is executive vice president and cohead of U.S. Listings and Cash Execution at NYSE Euronext.

And, finally, I would like to welcome Mr. Edward S. Knight, the executive vice president and general counsel at Nasdaq OMX Group.

Ms. Cross, please proceed.

STATEMENT OF MEREDITH CROSS, DIRECTOR, DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION

Ms. CROSS. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, my name is Meredith Cross and I am the Director of the Division of Corporation Finance at the Securities and Exchange Commission. I am pleased to testify today on behalf of the Commission on the topic of capital formation.

The SEC's mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Companies

of all sizes need cost effective access to capital to grow and develop. The Commission recognizes that any unnecessary regulations may impede their ability to do that. At the same time, the Commission must seek to ensure that investors have the information and protections necessary to give them the confidence they need to invest in our markets. Investor confidence in the fairness and honesty of our markets is critical to the formation of capital.

Chairman Schapiro has instructed the staff to take a fresh look at some of our offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. The staff's review is ongoing and is focusing on a number of areas, including the number of shareholders and other triggers for public reporting, the restriction on general solicitation in private offerings, restrictions on communications in public offerings, and regulatory questions posed by new capital raising strategies.

Additionally, the Commission's recently formed Advisory Committee on Small and Emerging Companies, which includes representatives from a range of small and emerging companies and investors in those companies, will provide the Commission advice and recommendations about regulations that affect privately held and publicly traded small and emerging businesses. The Advisory Committee held its first meeting at the end of October and we look forward to receiving their recommendations.

My written testimony provides a more extensive update on our capital formation regulatory review, but I will briefly discuss a few of our efforts in this area.

The staff is currently reviewing the 12(g) triggers for public reporting by nonlisted companies and the characteristics of companies that should be subject to public reporting obligations. Under the existing rules, the Section 12(g) trigger is generally 500 shareholders of record and $10 million in assets. Section 12(g) was adopted in 1964 following a rigorous special study of the securities markets, commissioned by Congress and conducted by the Commission. Some have called for changes to the Section 12(g) thresholds in light of the significant changes in the securities markets since the enactment of Section 12(g). To facilitate the Commission's review of the issues related to the thresholds for public reporting, and those for leaving the reporting system, the staff is undertaking a robust study like the one conducted when Section 12(g) was enacted. The study should help the Commission determine whether and how the current thresholds should be updated in light of changes in companies, shareholders, and markets.

Chairman Schapiro also asked the staff to review the restrictions our rules impose on communications in private offerings, in particular, the restrictions on general solicitation. Some have cited the restriction on general solicitation as an unnecessary impediment to capital raising since only qualified purchasers are allowed to invest. Others support the restriction on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to find potential victims or unscrupulous issuers to condition the market. In analyzing whether to recommend changes in this area, the staff is preparing a concept release for the Commission to seek the public's input on the advisability and the costs

and benefits of retaining or relaxing the restrictions on general solicitation.

We are also assessing our rules, and the regulatory burdens they impose, with respect to communications in public offerings. Over the years, the Commission has taken steps to facilitate continued communication around public offerings, including most recently in 2005, when the Commission significantly liberalized the rules for the largest public companies. The staff is reviewing these rules and our experience with them to see whether any of the liberalizations should be adapted for smaller public companies.

Finally, as a part of our overall capital formation regulatory review, the staff is considering regulatory questions posed by new capital raising strategies, such as crowdfunding, and the scope of our existing rules for small business capital raising, such as the Regulation A exemption.

Thank you for inviting me to appear before you today. I would be happy to answer any questions you may have.

Chairman JOHNSON. Thank you, Ms. Cross.

Mr. Herstein, please proceed.

STATEMENT OF JACK E. HERSTEIN, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

Mr. HERSTEIN. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. I am Jack Herstein, Assistant Director of the Nebraska Department of Banking and Finance, Bureau of Securities, and President of the North American Securities Administrators Association. NASAA represents State securities regulators.

Our members have protected Main Street investors and facilitated access to capital by small businesses for the past 100 years. My colleagues and I are acutely aware of the present economic environment and its effects on job growth. Because we realize that small businesses are vital to job growth and improving the Nation's economy, State securities regulators have no interest in throwing up needless roadblocks for small businesses. Instead, we are interested in creating ways to spur economic development and job creation.

Small business investment has the potential to be a very positive economic force and a major driver of wealth and jobs when done in the right way. But when done incorrectly and without appropriate oversight, these investments have the potential to become costly failures. The challenge for Congress today is to balance the legitimate interest of investors with the legitimate goals of entrepreneurs.

Three principles have guided NASAA's thinking on the proposals pending before this Committee regarding the regulation of small business investment. First, Congress should not preempt State securities laws. Preempting State authority is a very serious step and should never be done without a thorough examination of all available alternatives. While decreasing Federal regulation over small business capital formation may be appropriate, several proposals under consideration by Congress would needlessly preempt State law. Instead, Congress should give States greater flexibility to create innovative regulations that allow small businesses to use mod-

ern methods of attracting investors and provide appropriate disclosures.

Second, while the desire to facilitate access to capital for new and small businesses is warranted, Congress must be aware to do so in a careful and deliberate manner. If investors lack faith that small business offerings are being regulated to their satisfaction, they will be unlikely to invest their capital in these companies. This would undermine the very markets these bills seek to promote.

Third, Main Street investors should not be treated as the easiest source of funds for the most speculative business ventures. If a company cannot get financing from a bank, an SBA loan, a venture capital fund, or even friends and family, it is probably because the funding sources have determined that the investment is extremely risky. The law should not provide less protections to small, unsophisticated investors who can least afford to lose their money.

My written testimony offers detailed observations and suggestions regarding the capital formation bills pending before the Committee. I also direct the Committee's attention to a letter sent by my colleague, Massachusetts Secretary of the Commonwealth William Galvin, outlining our joint concerns about the serious consequences of S. 1831, which removes the ban on general solicitation and offerings under SEC Rule 506.

I would like to focus the remainder of my time on the proposal that has received the lion's share of public attention, the establishment of a registration exemption for crowdfunded securities as proposed by H.R. 2930 and S. 1791.

Crowdfunding began as the way for the public to donate small amounts of money, often through social networking Web sites, to help creative people finance their project or causes. Think of it as passing the hat through the Internet. But investing is a totally different matter.

Just last month, the House of Representatives approved H.R. 2930 in a remarkable 7 weeks after its introduction on September 14. This bill would create a massive hole in the investor protection safety net. NASAA believes S. 1791, with its lowered dollar thresholds, is closer to what was originally meant by crowdfunding.

Balancing the needs of small businesses and investors requires a degree of regulatory flexibility and creativity. Crowdfunding presents us with one of those challenges, but the States are committed to accommodating the needs of small businesses by adopting an innovative exemption to permit crowdfunding. Instead of preempting States, as both bills would do, Congress should allow the States to take a leading role in implementing an appropriate regulatory framework for crowdfunding. The best approach would be for Congress to direct the SEC to work with the States to fashion the Federal exemption in tandem with the State model rule.

If regulatory authority is preserved for the States, NASAA will continue to pursue the development of its model exemption for crowdfunding, which I discuss in detail in my written testimony. The model's most notable feature is that it would allow a one-stop filing in the State of the issuer's principal place of business. This streamlined approach can be achieved without preempting State securities regulators and is consistent with the goals of both Congress and the Obama administration to help small businesses ac-

cess the capital they need in order to promote economic recovery and job growth.

Given the small size of the offering, the small size of the issuer, and the relatively small investment amounts, States have the most direct interest in these offerings. States also are in the best position to communicate with issuers and investors to ensure that this exemption is an effective means of small business capital formation. States are most familiar with local economic factors that affect small businesses and States have the strongest interest in protecting investors in these types of offerings.

In closing, NASAA firmly believes that the States should be the primary regulator of small businesses and capital formation, including crowdfunding offerings. I would particularly appeal to those of you with roots in State government who may be skeptical of Federal efforts to preempt State law. Your background gives you a unique perspective on the dynamic and dependable role States play in serving your constituents, both investors and small businesses alike.

Thank you.

Chairman JOHNSON. Thank you, Mr. Herstein.

Professor Coffee, please proceed.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY LAW SCHOOL

Mr. COFFEE. Chairman Johnson, Ranking Member Shelby, other Members of the Committee, thank you for inviting me.

I share the goals of the sponsors of this legislation. I am not saying no. I am saying instead that the means chosen in several of these cases are unnecessarily overbroad and we can target the new exemptions a little bit more surgically so they apply to smaller issues and not lots of other companies who are very large but would like to "go dark" or would like to do other things that should give us considerable concern.

Now, two of the bills before the Committee, S. 1544 dealing with what is called the Reg A exemption, and S. 1831, dealing with general solicitations of accredited investors, in my judgment, make quite serious and reasonable attempts to improve the access of small issuers to capital markets without sacrificing investor protections. I have a number of comments on these, but basically, I support the idea. I just have tweaks on the language that are in my testimony.

The next bill, S. 1791, or the crowdfunding bill, is, I am sure, well intentioned, and we are all Internet friendly and we all like the idea of tweeting for investors. Nonetheless, in its current form, this bill could well be called the "Boiler Room Legalization Act of 2011," because it would, I think, occasion a reemergence of boilershops across the country. Nonetheless—again, I am not saying no. I am saying, with some relatively modest adjustments, I believe that the potential for fraud and abuse could be substantially curbed without preventing the use of the Internet, and I will get back to that in a minute.

Finally, S. 1824, which would raise the threshold at which a company must become a reporting company and make continuous public disclosure, this bill gives me the greatest concern because it

could, in its broadest form, represent a major retreat from the principles of full disclosure and transparency which have long characterized our capital markets. But again, I am saying not that 500 is a limit that is sacred, but we have got to update. We are using a concept called "shareholders of record" here which has become obsolete and archaic. I think there are better tests that could be used, whatever way you want to calibrate the point at which you have to enter the continuous disclosure system. And there are some simple steps that some are proposing that I think could be adopted tomorrow.

For example, one of the problems out there is that we count shareholder employees toward the 500 shareholder limit, and if these shareholders are receiving stock underneath employee benefit plans, which are exempt from registration, I think it follows quite consistently that those same employee shareholders should not be counted toward whatever limit we have, whether it is 500, 700, or some other test that I will propose.

My problem is, again, that shareholders of record are subject to manipulation. You can reduce them. It is actually possible today to take a company that might have 3,000–4,000 shareholders and reduce those beneficial shareholders holding stock in street name to maybe only 1,000 or less shareholders of record. And once you create an incentive for gaming like that, we will see people pick up on those incentives.

Now, let me just talk briefly about some of the bills before you. S. 1544, the Reg A exemption, I think it is a very significant idea that could have some impact, but again, on the topic of preemption of State law, I would suggest it is a problem if you have to comply with 50 different States. But if NASAA could come up with a uniform exemption, I do not think there is a serious grounds for preempting one uniform exemption because these kind of offerings are below the SEC's natural radar screen. You have to rely on the States to enforce fraud at the smaller level.

S. 1831, the general solicitation, I think that is the least controversial proposal before you, but the language does not quite work and I make some suggestions.

Now, with respect to crowdfunding, let me just explain what the problem is. There are two exemptions here. There is the issuer exemption from registration and there is a special broker-dealer exemption for the crowdfunding intermediary. It is the second one that concerns me. Let me sketch what I think will happen under this bill.

A character vaguely resembling Danny DeVito, who may have been barred for life from the securities industry, now enters the field as an unlicensed salesman. He sets up shop in a barroom, flips open his laptop on the bar or the Starbucks counter, and begins showing glossy PowerPoint slides to customers of allegedly high-growth companies. Maybe these companies are real or maybe they are fictitious. While I recognize he can only sell 1,000 to a customer, he can sell each customer 10 different companies and get to 10,000 that way. So he can really deplete people's assets by selling multiple companies.

Now, maybe he is paid by the crowdfunding intermediary, or maybe he is simply pocketing the proceedings on his own because

these are fictitious companies. But there is the problem here that this unlicensed salesman with no self-regulatory body supervising him can do almost anything.

How to curb this problem? My basic proposal is this. Keep the broker-dealer exemption for the crowdfunding intermediary narrow so that the intermediary must remain passive and cannot solicit sales. The issuer can solicit, but the issuer should have to use registered broker-dealers who are subject to the oversight of FINRA and the industry. That is my basic proposal, and let us use the Internet. But when you get to how you make the actual solicitations, whether it is oral or by email, there, I think it should be actual broker-dealers who are licensed and subject to control and not these unlicensed salesmen who will sneak under this.

Finally, in the last 10 seconds, when we look at what we should do about defining when you become a reporting company, I think we should junk the idea of shareholders of record, which can be gamed, and turn instead to the concept of public float. Public float looks at the market value of the securities held by public shareholders, not employees, not affiliates, but that is the test that tells us the need for disclosure. And I think if you used a test like $500 million of public float, that would give you a much better test that could not be manipulated. Where you draw that line is up to the Congress, of course, but I think you should use a line that is more adjusted to market realities.

Thank you.

Chairman JOHNSON. Thank you, Professor Coffee.

Would Senator Toomey care to share some comments about Mr. Gheysens.

Senator TOOMEY. Thank you very much, Chairman Johnson, and thanks for giving me the opportunity to introduce Mr. Christopher Gheysens, the Executive Vice President, Chief Financial and Administrative Officer for Wawa, Inc., which operates convenience stores and gas stations in the Mid-Atlantic region and can trace its history back over 200 years. Wawa is headquartered in Wawa, Pennsylvania, in the greater Philadelphia area, and employs 16,000 people throughout Pennsylvania, New Jersey, Delaware, Maryland, and Virginia.

Mr. Gheysens has worked at Wawa for over 14 years and became CFO in January of 2006. As CFO, Mr. Gheysens is responsible for leading all aspects of Wawa's financial, legal, and human resource functions. In addition, Wawa has recently announced that he will become President of Wawa, Inc., on January 1, 2012, and President and CEO on January 1, 2013.

Mr. Gheysens graduated from Villanova University in 1993 with a Bachelor of Science in accountancy. He earned his Master's of Business Administration from Saint Joseph's University and is a CPA in New Jersey.

I am delighted that Mr. Gheysens could be with us today and I welcome his testimony before our Committee.

Chairman JOHNSON. Mr. Gheysens, please proceed.

STATEMENT OF CHRISTOPHER T. GHEYSENS, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL AND ADMINISTRATIVE OFFICER, WAWA, INC.

Mr. GHEYSENS. Thank you, Senator Toomey, for that introduction. Good morning, Chairman Johnson, Ranking Member Shelby, and other distinguished Members of this Committee. Thank you for allowing me here today to testify on what I believe are really two of the most pressing issues, along with others here, job creation and capital formation. My name is Chris Gheysens. I am currently the Executive Vice President and Chief Financial Officer of Wawa, Incorporated. I am happy to be here today to testify on behalf of the company.

Wawa is encouraged by the strong bipartisan support that all the legislation relative to job creation and capital formation has. Specifically, however, I am here to talk about S. 1824, the Private Company Flexibility and Growth Act. That has the most significance to Wawa and many private companies. I would like to thank Senator Toomey and Senator Carper, as well as Senators Warner, Kirk, Johanns, and Senator Scott Brown for cosponsoring and introducing such important legislation.

Let me share my thoughts and insights as to why this is significant for Wawa and other private companies. First, our company was founded over 100 years ago in the Philadelphia region in the Delaware Valley. We were incorporated in the State of New Jersey in 1865 and we are headquartered in Wawa, Pennsylvania. Today, our modern day business of convenience store and retailing began in 1964 with our first store opening in the State of Pennsylvania. That was the same year the 500 shareholder limit went into place. Since then, Wawa and many other private businesses have expanded, have grown, and have dramatically changed.

Today, we have over 16,000 associates and almost 600 stores across five States, the States of Pennsylvania, New Jersey, Virginia, Delaware, and Maryland. However, in that same 47-year period, the 500 shareholder rule has not kept pace with the growth in our business and many other private businesses as well as the economy and the securities markets. Without change, Wawa and others will be limited in their growth and being able to create jobs going forward.

Our success at Wawa over the long term is really founded in two principles which are an important part of my testimony, being privately held and sharing ownership with our associates. First, on being privately held, it affords us a long-term point of view. For example, we plan and think in terms of decades, not quarters. Additionally, being private allows us and many other private companies to invest more significantly in our associates. Another example, in the recent economic downturn, Wawa created more jobs, hired more associates. In addition, we increased—significantly increased—our retirement plan contributions to a level that is the highest of several hundred companies that we benchmarked against.

The second guiding principle of sharing ownership with our associates has given our associates a significant stake in our company. Today, Wawa associates own approximately one-third of Wawa's company through an ESOP and through a broad stock-based com-

pensation plan for managers. This equity compensation has been an important part of what has enabled us to attract and retain associates and will continue to be an important part in the future as our business grows.

The combination of being privately held, the combination of our privately held and associate ownership, gives us a unique competitive advantage. We have a workforce that is a highly engaged set of associate owners. Our corporate culture is based on this, our corporate DNA, and these things are not negotiable for us.

In the near future, without a change and an increase in the 500 shareholder rule, Wawa would be forced to redirect capital, in our case, tens of millions of dollars, away from building new stores and creating new jobs just so we can reduce and restrict the number of shareholders we have to remain private under these outdated rules. Many of those shareholders that would be eliminated would be shareholders that are associates today and working for Wawa. That goes against one of the core principles that has made us successful.

So in conclusion, we believe it is necessary to take action now on the Private Company Flexibility and Growth Act so that Wawa and other private companies can continue to focus on job creation and spurring economic growth.

Thank you for the time to testify today and I look forward to any questions you may have.

Chairman JOHNSON. Thank you, Mr. Gheysens.

Mr. Cutler, please proceed.

STATEMENT OF SCOTT CUTLER, EXECUTIVE VICE PRESIDENT AND CO-HEAD OF U.S. LISTINGS AND CASH EXECUTION, NYSE EURONEXT

Mr. CUTLER. Chairman Johnson, Ranking Member Shelby, Members of the Committee, my name is Scott Cutler, Executive Vice President of NYSE Euronext, the world's leading exchange group and the number one capital raising venue in the world. I appreciate your invitation to testify today.

The bills pending before this Committee are focused on opening up the private markets to broader pools of investors. As important as it is to encourage capital formation in those private markets, it is even more critical to look at the capital our public markets provide young, growing companies and examine the ways to make it easier and more cost effective to access our public markets. Young, innovative companies are the engines of job creation and access to capital through initial public offerings is key to allowing these innovative companies to grow and hire new employees.

When looking at ways to stimulate job creation through capital formation, we need to look at both private and public markets. However, it is also important to understand the differences between the well regulated and transparent public markets and the private markets that provide investors with much less protection, reduced or no issuer disclosure, and low levels of liquidity. The private markets have an appropriate role in addressing capital and liquidity needs for certain issuers and shareholders and we support methods of private capital formation that facilitate growth. However, issues of transparency, disclosure, and liquidity in these mar-

kets must be addressed as these markets expand to an ever-increasing larger set of investors.

Investments in private companies are highly risky and historically have been limited to investors that can understand, evaluate, and financially bear the risks. Any proposal to greatly expand the role of private markets must require a high level of investor sophistication and a relationship with the issuer or its placement agent such that the investor is known and can understand the risks or a sufficient and uniform amount of disclosure such that less sophisticated investors understand what they are investing in.

As for the specific legislative proposals, first related to crowdfunding, allowing entrepreneurs to raise capital through crowdfunding is an important step to encourage new business and growth. However, investor protections are needed. Any crowdfunding exemption should, therefore, include low limits on total offering size and on the amount that any individual can invest and require the issuers disclose sufficient information to assure that investors understand what they are purchasing.

As it relates to Regulation D, the restriction on general solicitation has been a core feature of the private placement exemption and is an important safeguard to avoid fraud against investors. It is the key limitation which protects the general public from being drawn into highly risky and unsuitable private investments.

On Regulation A, the NYSE applauds the House for passing the Small Company Capital Formation Act of 2011 and commends Senators Tester and Toomey for their leadership on this. This bill would help small companies access significantly more capital through Regulation A offerings without the expense of full regulation under the Securities Act. At the same time, investors are protected as Regulation A securities are offered with significant disclosure regarding each issuer.

We also support the Private Company Flexibility and Growth Act as passed by the House, which would increase from 500 to 1,000 the level of beneficial shareholders which would force public information disclosure. Importantly, this would also exclude employees from that count.

Finally, NYSE supports the recommendations laid out by a Private Sector IPO Task Force recently released. Young companies are the true job creators and IPOs have had a significant impact on job creation. Ninety-two percent of job growth occurs after a company's IPO and most of that within the first 5 years of an IPO. However, unfortunately, over the past decade, the number of companies going public has significantly decreased due to burdensome regulatory hurdles. The Private Sector Task Force recommendations would significantly reduce the obstacles that prevent IPOs, yet maintain important investor protection. They suggest creating a 5-year on ramp for emerging growth companies, which would include any company pursuing an IPO. Importantly, this would not affect any company that is already public. For this small number of emerging growth companies, certain disclosure and other public company regulatory requirements would be phased in, thus lowering the costs associated with the IPO and initial burdens of complying with certain public company requirements. This would give

emerging growth companies the chance to go public, expand and hire before incurring this expense.

In closing, I applaud your focus on capital formation and encourage you to consider reforms for both public as well as the private markets as both are critical to this process, and I appreciate the opportunity to testify before the Committee this day and am happy to answer any questions you may have.

Chairman JOHNSON. Thank you, Mr. Cutler.

Mr. Knight, please proceed.

STATEMENT OF EDWARD S. KNIGHT, GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT, NASDAQ OMX GROUP

Mr. KNIGHT. Thank you, Mr. Chairman, and thank you for the opportunity to testify today before this distinguished Committee. Ranking Member Shelby, it is a pleasure to be back here.

I have to tell you, this subject is a subject that is a very passionate topic at Nasdaq right now, and this hearing comes at a very critical moment in our economic history. We have a jobs crisis in this country, and we need to do something about it. We do not have a lot of money to spend to deal with this crisis, and we think one way to get dramatic action in this area is through showing some attention to the public equity markets.

The legislation you have before you today is very important. It deals with the private markets. The private markets work hand in glove with the public equity markets. We want them to be strong. We want them to have the most modern regulation and up-to-date regulation. And we think there is a lot of merit to the legislation you are considering.

But as we make it easier for companies to choose the private company route and avoid public capital markets, either by staying private or by going overseas to list, we should also deal with structural issues that make the U.S. public markets less attractive than they could be.

We know it is not your intention, but we think if the Committee acted only on these bills, it could be interpreted as a sign of retreat from the public markets. We strongly urge the Committee to expand the scope of this action and look at reforms of the public markets.

Now, some might ask, If you can access the capital you need from the private markets, what is the concern? I will give you three reasons.

One, jobs. A healthy public equity market enables companies to raise capital more efficiently, funding more rapid growth and more jobs. Companies create 90 percent of their new jobs after they go public. Companies create 90 percent of their new jobs after they go public.

Second, efficient pricing. A public company trading on a public market provides the most efficient pricing and funding of entrepreneurial activity. It is well recognized that companies that do not trade on transparent exchanges or exchange-like venues are valued at a discount.

Third, public access. A public listing allows access to ownership by the most diverse universe of investors. At Nasdaq, we believe that equity ownership and participation as shareholders in entre-

preneurial-led growth should be widely available to the public. We may be biased, but we believe an initial public offering is the best policy outcome in terms of jobs.

But I want to be careful here. I do not want to look like I am talking our own book, so let us look at the facts.

From 1995 to 2010, listings on U.S. exchanges shrank from 8,000 to 5,000 companies, while listings on non-U.S. exchanges around the world grew from 23,000 to 40,000.

The U.S. averaged 398 IPOs per year in the 1990s while in the last 10 years it has only been 117. Today IPOs are much larger in size because of, as we are told over and over again, the increased regulatory costs associated with the public company model. I am not suggesting that the health of the U.S. economy is directly tied to the number of IPOs on Nasdaq or the number of listings on U.S. exchanges. But I do know—and my testimony spells it out in more detail—when IPO capital formation is restricted, entrepreneurs are incented more often to create products that complement the existing products of large companies rather than creating transformational products.

Moreover, entrepreneurs may be tempted to sell their ideas too cheaply in the private markets. In the broadest terms, we believe resources are inefficiently allocated when public capital formation is unnecessarily constrained.

How do we improve these markets? Two areas: the regulation of the markets themselves and the regulation of the companies.

We embrace some recent studies. I point to the President's Council on Jobs and Competitiveness and the IPO Task Force which Scott mentioned earlier. There are four ideas that come out of that. Our goal should be to restore the ecosystem that used to exist to support these companies. When I talked to my colleagues on what is the difference today than in the 1990s, they say that ecosystem no longer exists. How do we get that ecosystem started again?

One issue that comes up over and over again, and to a person, when I ask people why do people say they do not want to list publicly, why do they list outside of the United States, the issue that comes up over and over and over again is 404. 404 needs to be reformed in Sarbanes-Oxley. PCAOB retains broad powers in this area. They can act to police the accounting industry without imposing this burden on public companies. The President's Council recommended a $1 billion—and opt-out for companies from 404 that are valued $1 billion or below. We endorse that.

Second, we believe we need to adopt the ramp-on idea that, again, Scott mentioned that is in the IPO Task Force recommendations that were delivered to Treasury that I believe is embraced in Senator Toomey and Senator Schumer's bill in dealing with regulation in this area and scale up regulation for smaller companies. This scaling of disclosure and administratively burdensome regulations we think will help jump-start this area.

Third, a venture capital market. We think we need special rules for a venture capital market in the United States. Vancouver has 2,100 companies on their venture market. We run a venture market in Sweden that is very successful. But we need the SEC's help to create some trading rules in that area.

And, fourth, the SEC has had before it for over a year—2 years, in fact—a market structure reform set of recommendations embodied in a concept release. We think we are overdue to act upon that and revise the market structure in the public markets to reduce fragmentation and darkness.

Let me close by saying Nasdaq is not opposed to regulation. We are one of the most heavily regulated businesses in the world. This year we will make 400 rule filings with the SEC just to keep our business going. We believe in this regulation. It has served the public well. But if you study the public company model and the empirical evidence from the last 10 years, you will clearly find that in some areas we have gone too far and in other areas we have been neglectful. This is not a partisan issue. There is no need to assign blame. We all want more and better jobs in the United States. The public equity markets have been the best source of jobs in this economy and in this country, and attention should be paid to those markets.

Thank you.

Chairman JOHNSON. Thank you, Mr. Knight.

I would like to thank all of our witnesses for their testimony. As we begin questions, I will ask the clerk to put 5 minutes on the clock for each member.

Ms. Cross, Mr. Gheysens, Professor Coffee, and Mr. Knight, the securities laws require a company to register when it has 500 shareholders of record. Professor Coffee has testified that record ownership is easily manipulated and companies could come to have 5,000 or more beneficial shareholders and begin stock market capitalization without becoming subject to the increased transparency required by registration.

Ms. Cross, Mr. Gheysens, Professor Coffee, and Mr. Knight, what are the advantages and disadvantages of the current way of counting shareholders of record? Ms. Cross.

Ms. CROSS. Thank you. I would say that companies would say that the certainty of using shareholders of record makes it easier to count. Beneficial holders requires that you look through broker-dealers to find the number, and if you are a public company with your securities trading, that can take some time and would lead to some uncertainty. You can control your number of holders when it is the record holders because you can have restrictions on transfer. But you cannot control it if they are trading through, for example, DTC.

These questions, though, are important in deciding whether or not the 12(g) test is correct. The statute refers to holders of record. The Commission has currently tasked the staff with studying whether we should change that by rule to look through to beneficial holders. If we do that, I would say that the number would almost certainly need adjusting because if you do look through to beneficial holders, the number gets much larger.

Chairman JOHNSON. Mr. Gheysens.

Mr. GHEYSENS. I agree that the current advantages of—it is a long-time rule, and the current advantages, especially at Wawa, are it is simple and easy to understand to count shareholders of record. At Wawa we do have beneficial ownership in a family trust and also in an ESOP, an Employee Stock Ownership Program. The

family trust has been in existence since 1922, before these rules we are discussing today even were formed originally. And our ESOP certainly is a valid cause in trying to provide for associate ownership and long-term retirement planning, which we give to our associates.

So disadvantages of looking through in my understanding is there are rules today that the SEC could enforce if beneficial ownership is causing reason to avoid or evade public reporting, which is something Wawa and many companies that we work with would not do.

Chairman JOHNSON. Professor Coffee.

Mr. COFFEE. We are talking about updating obsolete law, and I am in favor of updating obsolete law. The concept of record ownership, which was quite normal back in 1964, has become obsolete because most shareholders hold stock beneficially. I would suggest either that you could have the SEC redefine record ownership. If they find that Merrill Lynch is holding shares as one record own for 50 or 500 or 5,000 different shareholders, there should be some adjustment made. We should not ignore that. We do not have to be blind.

I do recognize that you cannot easily count beneficial shareholders, which is why I was suggesting something that is used in other contexts, which is the public float. You look at the value of shares, which is easily computed—you look at the market price—and you say the shares held by the nonaffiliates and the nonemployees. This would also solve the problem of Wawa because we would not count employee shareholders against this limit. We would say that if there is a certain level of public ownership and it is above a value, let us say $500 million, then that company really should make disclosure to the market and investors. We do that under what is called Form S–3, where we use a $75 million public float test, so it is used in some contexts. Something like this could be used in this context.

Chairman JOHNSON. Mr. Knight.

Mr. KNIGHT. We support the legislation as proposed. We feel, as Professor Coffee has indicated, that it is time overdue for reform. It is widely supported in the investment community and among members of the securities bar. I think, though, Professor Coffee raises some important technical issues that should be addressed here.

Chairman JOHNSON. A recent column in the Detroit Free Press said crowdfunding could be a part of the picture to generate jobs, but that picture could get very ugly quickly if reasonable protections are not part of the mix.

For all the panelists, what safeguards do you recommend for crowdfunding to be successful for businesses and investors alike? Ms. Cross.

Ms. CROSS. Thank you. First of all, as our written testimony notes, I do not participate in crowdfunding matters because of my prior work for a peer-to-peer lender, but our written testimony jointly with my Deputy, Lona Nallengara, includes a description of factors that should be considered in the crowdfunding arena. The list that I would note for your benefit would be: a limit on the aggregate amount of funds that can be raised, both by a company and

invested by an individual; requiring basic information to be provided to potential investors, for example, about the business, the planned use of funds raised, principals, agents, and finders; requiring crowdfunding transactions to be placed through an intermediary that is subject to some sort of oversight; restrictions on participation by individuals or firms that have been convicted or sanctioned for prior securities fraud; requiring issuers to file a notice with the Commission so the Commission knows what is going on in this area; and restricting transfer of securities sold in crowdfunding so that you do not end up with the pump-and-dump schemes that were so problematic in the late 1990s.

Chairman JOHNSON. Mr. Herstein.

Mr. HERSTEIN. Thank you, Senator. I would echo Ms. Cross' comments except I would add that the preemption that is currently in both bills be lifted. That way they would also have to do a filing with the States, and the States could then basically make sure that the States' investors are given proper disclosure, and the States could also be aware of what is happening within their borders.

I agree that crowdfunding could create jobs, would help the economy, but, again, you are basically talking about unsophisticated investors probably buying most of the securities regarding crowdfundings, and there needs to be some protections there.

Chairman JOHNSON. Professor Coffee.

Mr. COFFEE. I would say that we should move in the direction of allowing the issuer to use the Internet. The issuer should be able to post its PowerPoint slides on a Web site, including a crowdfunding intermediary's Web site. But at that point, I am very nervous about the intermediary being able to directly solicit investors without being a licensed broker-dealer. The unlicensed salesman directly marketing securities to unsophisticated customers defines what the old boiler room was. We want people who directly sell securities to customers to be broker-dealers because that gives them the oversight of both SEC rules, some professional training and examination, and the FINRA disciplinary process. Once we drop that net, we are playing tennis with the net down on a very new playing field that I think is quite dangerous.

So go forward with the Internet, but try to keep the crowdfunding intermediary passive so it displays this but does not directly solicit investors. The issuer could solicit investors through registered broker-dealers. That I think is the safe way to go, and it does allow you to use the Internet.

Chairman JOHNSON. Mr. Gheysens.

Mr. GHEYSENS. Thank you, Senator. Crowdfunding is really not pertinent or relative to Wawa, but certainly from a position of capital formation, while also protecting investors, it certainly makes sense given there is a balance in that approach.

Chairman JOHNSON. Mr. Cutler.

Mr. CUTLER. We would agree that the opportunity for additional access to capital is important, and crowdfunding can provide that necessary capital. I think we also have to understand, however, that these investors are not as sophisticated as a typical venture investor. When a company is offering securities to sophisticated investors, these investors typically demand certain information rights; they demand certain investor protections, corporate govern-

ance provisions. And the types of investors here that we are talking about would not be subject to those types of investor protections.

And so we support, for example, the bill introduced by Senator Brown which puts a maximum offering size as well as a limit on the individual investor amount and, importantly, adds additional investor protection or disclosure matters so that investors know what they are investing in and are protected in the types of investments they are making.

Chairman JOHNSON. And, last, Mr. Knight.

Mr. KNIGHT. I will be frank with you, Mr. Chairman. The experts and practitioners and law professors and others that I have consulted on this—and we are just getting up to speed on this idea—recommend caution in this area for just the reasons that Scott mentioned and that Professor Coffee mentioned because of the nature of the investors. I think it would be also important to hear from organizations like FINRA about their views in this area.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Knight, in your testimony you recommended several significant regulatory reforms, including reforming Sarbanes-Oxley, rejecting "expansive and expensive new regulations on public companies," and allowing public companies to trade only on the market on which they are listed. If enacted, how would these reforms impact the number of listings on U.S. exchanges? And how could such reforms improve the attractiveness of U.S. capital markets as compared to our foreign competitors?

Mr. KNIGHT. Thank you, Senator. In several ways, but I want to emphasize, one, this is not just about Nasdaq. It is not just about the New York Stock Exchange and how many listings we get or how many fees we collect in this area. But we happen to be on the front lines——

Senator SHELBY. But it is about our competitiveness.

Mr. KNIGHT. It is, and we happen to be on the front lines selling to investors, to entrepreneurs, to companies overseas the merits of the U.S. markets. We do it every day. We are proud to do it. We have a license from the U.S. Government to do it. We are heavily regulated because of that, and we understand why that happens. But we hear over and over again and we see from the empirical evidence that people do not view our markets very attractively, that they choose—even U.S. companies are choosing to list overseas. And we look behind that at where the resistance is, and often it is what I would call a lack of scaling in regulation, that we pass laws with good intentions, we had a company in mind that is typically much larger, and the smaller companies are just not in the position to spend that sort of money.

Now, I hear the accounting industry, for instance, say it does not cost a few million dollars to comply with 404, it may be only a few hundred thousand dollars. And I am not just trying to get on Scott's—in his face, but Viacom switched from the New York Stock Exchange to Nasdaq a few weeks ago and issued a press release that said it was because of the savings associated with the listing with Nasdaq. That is $400,000 for a $14 billion company. Now, if $400,000 makes that much difference for a $14 billion company, how about a $5 million or a $10 million company or an Israeli tech-

nology company that can go to London, it can go to many other markets to access the global capital markets? They will not come here with that.

And when you look at what 404 has accomplished, I think it is hard to point to a lot of achievements in that area. It makes sense for a lot of big companies. There is a lot of good that comes from it from big companies. But even with that, we have had problems with MF Global. It did not seem to affect much the financial firms that ran into crisis in 2008. So I just think it is time to look at it soberly, just like we looked at our antitrust laws and many other economic statutes and amended them over time.

Senator SHELBY. Mr. Knight, you also point out in your testimony that the Public Company Accounting Oversight Board is a source of additional regulatory burdens on public companies. I recently introduced a bill that would require the financial regulators, including regulatory bodies such as the PCAOB, to conduct economic analysis, cost/benefit analysis. Would such a requirement help to improve the regulatory requirements without compromising investor protection that we all care about?

Mr. KNIGHT. I think now is the time to look at things like that. I think it is consistent with the scaling proposals which, in essence, are saying that the benefits of the regulation to small companies are outweighed by the costs associated, that the benefits are limited. And I think that sort of thinking is needed now as we struggle to restore the jobs to our economy.

Senator SHELBY. Ms. Cross, the shareholder threshold study, specifically what questions do you hope to answer in this study at the SEC? And how soon could you provide this Committee with the results of the study? And, obviously, what—and when will the SEC use the results of this study, if they use them? Where are you on that study?

Ms. CROSS. We are deep into the data-gathering stage of the study. We are also preparing a request for public comment to get input from those where it is difficult to get the information. You might imagine that as we try to get information from private companies about themselves, private companies are private, so it is a little bit difficult to get that information.

We are asking a full range of questions. We think it is important to understand what are the characteristics of companies that are getting forced to start reporting before they may think it is appropriate to do so. We want to know, for example, how many are having to become reporting companies because their employee numbers go high or, for example, do companies have to start reporting in certain industries sooner than others, things like that.

On the timing, we are working on the study now. We expect to complete it during 2012 and get the results to the Commission so they can act.

Senator SHELBY. Will you get the results to the Committee?

Ms. CROSS. I am happy to report out, yes.

Senator SHELBY. OK. Ms. Cross, the utility of Regulation A, you are very familiar with this. As you noted in your testimony, last year only three Regulation A filings were qualified by the SEC. So far this year not a single Regulation A filing has been cleared. Aside from the change to the threshold amount, are there any

changes that could be made to make Regulation A more appealing to companies?

Ms. CROSS. That is a very good question. We are not sure why Regulation A is not appealing to companies. Things like the fact that the filings are not made on EDGAR may be relevant. The companies that do Regulation A offerings tend to be pretty unsophisticated. For example, one of the filings recently was handwritten. We think that it is an area that has not taken off because people are not very familiar with it. I think that perhaps modernizing the disclosure scheme would make a difference. The size is probably relevant as well.

Senator SHELBY. I have one last question. If I can, I will direct it to Mr. Cutler and Mr. Knight. Can either of you for the record here provide any data about the regulatory costs that a company faces in connection with this initial public offering and in the years immediately following the IPO? And could either of you provide any data for the record here with respect to the cost savings—you mentioned this earlier—that a company would experience as a result of regulatory reforms that have been recommended here? Mr. Cutler, do you want to go first?

Mr. CUTLER. Sure. If you look at the recent recommendations from the IPO Task Force, importantly they cite the costs of numerous regulations, one of them being Section 404 compliance which, for most companies going public, averages somewhere between $1.5 to $2 million for the initial year going public, which is often cited as the key hurdle for many companies going public. That number is only larger, the larger the enterprise. Additional costs around compliance with public disclosure requirements add to that cost, but that tends to be the most significant concentration of the costs of going public.

Senator SHELBY. Mr. Knight.

Mr. KNIGHT. I would like to come back to you with some detailed information on that, but Scott's statistics and, as I noted, the IPO Task Force also has statistics in its report that it delivered to the Treasury Department on October 20th, and I think that would be important for the record, too.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Yes, thank you, Mr. Chairman. I appreciate you holding this important hearing to examine the proposals before the Committee and their potential to create jobs and spur economic growth and spur innovation. I appreciate the panelists all being here and appreciate your testimony.

The critical component of achieving the goals that I talked about is ensuring that small businesses have access to capital, that they need to grow and create jobs. In July, I held a hearing to examine the challenges and opportunities that are facing innovative small businesses, many of which present the greatest opportunity for job creation in this country.

A key take-away from that hearing was the need to ensure that capital markets remained within the reach of those startups at various stages in their development, particularly in the stages before they may be ready to go public.

A key recommendation offered at that hearing came from a chap by the name of Robert Bargatze from LigoCyte Pharmaceuticals, headquartered in Bozeman, Montana. It was that we ought to take a closer look at updating Regulation A to better enable small businesses to raise capital through public offerings.

For LigoCyte, access to capital to fund their clinical trials for a new norovirus vaccine will be the determining factor in their ability to not only create jobs but to gain FDA approval for a critically important vaccine with the potential to prevent hospitalization and save significant health care costs.

In working with Senator Toomey, we were able to draft the Small Company Capital Formation Act, S. 1544, to update Regulation A by increasing the total amount of capital that can be raised through these public offerings to $50 million while providing new investor protections. Currently, businesses can only raise $5 million under Regulation A, a limit that has not been updated in nearly 20 years, and one that many view as too low to be a valuable tool in raising capital.

The bill maintains the most attractive elements of Regulation A, including the ability for issuers to test the waters before registering with the SEC but adds new safeguards. These include a requirement that issuers file audited financial statements with the SEC. It permits the SEC to establish additional disclosure requirements and requires issuers to electronically file offering statements with the Commission. Additionally, the bill subjects those offering or selling securities under this exemption to liability under 12(a)(2) and includes disqualification provisions to prevent bad actors from making these offerings in a way that is consistent with Dodd-Frank.

It is a balanced bill. It has garnered strong bipartisan support. Both President Obama and Senator McConnell support the bill. It recently passed the House by 420–1.

The bill is not a silver bullet that will fix all the ills that prevent small businesses from accessing capital, but it certainly is a common-sense measure that will provide an important avenue for high-growth, innovative companies to raise critical early stage capital that they need.

Ms. Cross, first of all, I want to say thank you to you and your staff at the SEC for the technical assistance and suggestions that you made on ways to improve our legislation. I think you have helped make it—I do not think—I know you have helped make it a better bill.

I am hoping that you might be able to clarify a few points for us. As I understand it, the Securities Act of 1933 provided the SEC with exemptive authority for offerings made under Regulation A and that the SEC has that authority to adjust this exemption as it sees fit. Can you explain that authority?

Ms. CROSS. Yes, and thank you for your kind remarks.

Section 3(b) of the 1933 act has an exemption for offerings of up to $5 million, and Regulation A was adopted under that authority.

In 1996, long after Regulation A was adopted, Congress amended the 1933 Act to add general exemptive authority in Section 28. The SEC could use the Section 28 general exemptive authority to in-

crease the cap in these offerings above the $5 million currently allowed under Section 3(b), so that authority already exists.

Senator TESTER. OK. And under this authority, I would guess that the SEC would have to make some sort of justification to make the adjustments for that exemption. Is that correct?

Ms. CROSS. Yes, that is correct. Section 28 requires that the Commission, in adopting any rules or regulations to provide exemptions under the 1933 Act, find that the exemption is necessary or appropriate, in the public interest, and consistent with the protection of investors.

Senator TESTER. OK. Some have suggested that increasing the exemption through this legislation and requiring the SEC to report periodically on the need to adjust the limitation would somehow provide the SEC with an unlimited or open-ended authority to increase the limitation under Regulation A. Could you respond to that?

Ms. CROSS. Certainly. As I noted, the Commission already has the authority to increase the cap for these offerings and could do that under Section 28, subject to the overall determination that such an exemption would be necessary or appropriate, in the public interest, and consistent with the protection of investors. The legislation would amend Section 3(b) to require the Commission to review the offering amount limitation every 2 years and increase it if it determines it to be "appropriate"—is the word in the section. In deciding whether it is appropriate, I would expect that the Commission would consider the factors it considers in using Section 28 exemptive authority; that is, is it in the public interest and consistent with the protection of investors?

Senator TESTER. And does the SEC have the authority to decrease that limit if they feel it is appropriate?

Ms. CROSS. The current—right. Currently under——

Senator TESTER. Not just increase but also decrease.

Ms. CROSS. Yes.

Senator TESTER. OK, good. Real quick—I am over time—some have suggested that this limitation should be capped. Could you respond to that?

Ms. CROSS. Again, I think because the Commission can adopt exemptions in general that do not have caps, capping this particular one I think would add confusion, frankly, to the way the 1933 Act works since, if the Commission found another exemption to be appropriate, it could adopt a different exemption with a different cap, and so capping this particular one I think could create some pretty serious confusion.

Senator TESTER. And as a regulator, it would restrict your ability to meet the needs of the marketplace, I would assume.

Ms. CROSS. I think it could. I also would note that while the Commission has not taken a position on this particular bill, there are a lot of investor protections built into it. And so when you consider the SEC filing, the 12(a)(2), all of that combined, I think that the Commission would presumably be able to act in a manner consistent with investor protection.

Senator TESTER. Thank you, Meredith.

Thank you, Mr. Chairman, for your latitude.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you very much, Mr. Chairman, and let me just add my thanks to you for having this hearing and pursuing this. As a former entrepreneur and with experience in finance in both large and small institutions, I have long been convinced that the formation of capital and access to capital is perhaps the single biggest driver of economic growth and opportunity. So I think what we are doing here is very, very important.

I have got three bills that address this in various ways, and they have been mentioned already. I want to thank Senator Tester for the great work that he has done on the Regulation A bill, which I am really quite optimistic about, given the very broad bipartisan support for that bill. Later today I will be unveiling with Senator Schumer a bill that he and I have that will facilitate IPOs, which I think is very constructive, and I think will also have broad bipartisan support.

But I would like to start my questions on the third bill, which is one that Senator Carper and I have introduced, which is the Private Company Flexibility and Growth Act. We have had some discussion about this, and I would like to start with Mr. Gheysens, if I could, with a couple of questions.

First, in your testimony I think you briefly alluded to a relationship between this bill and Wawa's ability to grow and create jobs, and I was wondering if you could just make that really clear to the Committee, the connection between passage of this bill and Wawa's ability to grow, to expand, and to create new jobs.

Mr. GHEYSENS. Absolutely. Thank you, Senator Toomey. Wawa's ability to grow since its inception in 1964 has not been hindered because the regulations at that point in time allowed us enough flexibility. However, today we have grown to a point where, going forward, because being privately held is so critical to being successful over the long term and being able to share and focus more of our ownership with our employees, therefore going forward the desire to remain private and the number of shareholders we have, we would be forced to redirect capital away from new stores, new growth, and job creation, dollar for dollar right into reorganizing and restructuring our balance sheet and our capital ownership so that we could eliminate and reduce or restrict the number of shareholders we have to remain in compliance with this outdated law.

Senator TOOMEY. So it is fair to say then that passage of this bill and having it signed into law would directly result in a more rapid expansion and greater job growth at Wawa?

Mr. GHEYSENS. Yes, Senator, exactly. These are the same dollars that we are going to deploy and will deploy with more flexibility to building new stores in the five States we are in as well as a new market versus putting them to work to just stay in compliance.

Senator TOOMEY. Right. Does it make any difference to you guys whether the ceiling on the number of permissible shareholders is lifted by regulation, presumably by the SEC, or through legislation of Congress?

Mr. GHEYSENS. It does not. Either Congress or by rule of the SEC, the process to us, we are indifferent. The importance for us really is the timeline. We are at an inflection point. Several private companies that we are aware of are at an inflection point, and really it is the timeline that is most important for us in order for us

to be able to dedicate that capital to growth instead of reserving it for these other activities.

Senator TOOMEY. And since this is going to accelerate your ability to create jobs, I would think the timeline matters to the people who have to get hired as a result, which brings me to my next question.

Ms. Cross, it is my understanding that the SEC has been considering this at various levels and in various ways for some period of time. Do you have any sense for a timeframe that you could give us by which the SEC would reach a decision about raising the shareholder limit?

Ms. CROSS. I would be happy to. As I noted in my testimony, when the limit was originally put in, it followed a robust study to understand the costs and the benefits and the economic consequences of a change in the rule. So we are doing that now. That takes time, I am afraid. So I expect that we would get the work done on the study during 2012, and then the Commission, if they decide they want to change the rule, would need to put out a rule proposal. So it is at least, I would have to say, you know, more than a year away.

Senator TOOMEY. OK. I just have to say that is disappointing. I know this has been a subject of consideration and on the agenda of the SEC's Government Business Forum on Small Business Capital Formation for several years. So if there is any way that that could move more quickly, that would be very helpful.

Ms. CROSS. Well, I appreciate that, and to the extent that we are able to get information such as that provided by Mr. Gheysens about the private company marketplace, that would really help. That is one of the things we are seeking right now. I think that is exactly the kind of information that we need.

Senator TOOMEY. I think Senator Shelby was engaged in a discussion about the cost of being a public company, if I remember correctly, and might have asked a question. I happen to have in front of me the number from the IPO Task Force suggesting that the average cost to go public is $2.5 million and the annual cost to stay public on average is $1.5 million. I think this is for smaller new companies. I am just wondering: Does that sound like I have got my figures right, Ms. Cross? Does that sound right to you?

Ms. CROSS. I do not have data on the cost of IPOs. We are studying the IPO Task Force report now as well, and they are the kind of group from which we can get that data. So I would have to assume they are correct. I think the amounts vary, of course, according to the size of the company.

Senator TOOMEY. Right, right. The last question I have is for Mr. Knight. In your testimony you mentioned that the PCAOB's recent proposal to require public companies to rotate auditors, it is an example of a regulation that is not clearly necessary, but it certainly is costly. I share your concern, and I am wondering if you could explain exactly why this is a very costly regulation for companies.

Mr. KNIGHT. Well, there is a ramp-up cost involved with when you hire a new firm in this area, and so you spend that money, and then you are going to have to bring in and rotate another auditing firm and go through that same process again.

When I take a step back and look at this, what it seems to me is an area where the PCAOB could focus more on is using their existing powers to oversee the accounting industry and not necessarily using them to, if you will, put more burdens on public companies. They have broad, broad powers to regulate every aspect of accounting firms in this country, and that authority should be used more. We all want the highest financial standards, accounting standards possible. Nasdaq would not exist today without the accuracy and the reliability of financial disclosures. The accounting industry has a lot of challenges in front of it, including unlimited liability and other issues. But the direction of regulation is—it seems to me too many times we turn to, well, let us add another requirement on public companies to deal with what I think is ultimately an issue of the accounting industry itself.

Senator TOOMEY. Thank you very much.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you all for your testimony. I want to note that both Senator Bennet and I share a real interest in the crowdfunding issue, and I am going to direct my questions in that direction. It seems like such a promising possibility but one also fraught with considerable danger.

Ms. Cross, you mentioned on your list that one of the things we should be concerned about or think about is a limit on aggregate amount for investors. But how does one implement such a cap?

Ms. CROSS. Well, you can certainly consider it in terms of in the particular transaction, such as, you know, whether they can invest $1,000 or $100, or pick a number, and then I think perhaps a harder question is across crowdfunding investments. I think that you could require—if you chose a number, if you want an individual not exposed to more than, say, $10,000 worth of crowdfunding in any given year, you could have a requirement be that there is a cap on the amount, and that would be part of the inquiry that the seller would have to make and the investor would have to represent that they do not have more than, say, $10,000.

I think it would be very difficult to otherwise police it, for example, but at least an investor would have to affirmatively not tell the truth in order to be able to invest.

Senator MERKLEY. Yes. So you were not proposing or thinking that there would need to be some kind of central reporting by Social Security number or something to implement such an aggregate cap?

Ms. CROSS. I imagine that would be awfully perceived as burdensome, but, again, the Commission has not taken a position on this legislation.

Senator MERKLEY. Yes. You also mentioned not allowing the transfer in order to avoid pump-and-dump, a huge, huge challenge. Were you thinking in terms of this type of annual restrictions or 1-year restriction? Or are you thinking of something much, much longer?

Ms. CROSS. Under the general securities laws now, if something is a restricted security, for example, sold in a private offering, sold in other kinds of exempt offerings like 701 employee offerings, Regulation S offshore offerings, for a nonreporting company they are

restricted for 1 year, and that is long enough, I would imagine, my own personal view, to keep the security from being something that is promptly used in a pump-and-dump scheme where, if the security can be traded right away, it is just handed over to a broker-dealer who uses a boiler room technique to bring the stock price up and dump it into the marketplace.

So the 1 year I do not think has been problematic in the other exempt offerings, and that would, I imagine, be appropriate.

Senator MERKLEY. Thank you. I want to turn to another area, which is the preemption of State blue sky laws, and the "blue sky" term goes back to, I believe, in Kansas, the sense that people were selling just blue sky and very little of substance behind the representations. Indeed, this is why we have had State blue sky laws.

One of the advantages, of course, of preemption is you create this consistent playing field across the country. However, we did see some enormous damage in the mortgage area when States were taken off the beat, if you will, from being able to regulate transactions within their boundaries.

Is there a strategy that would make sense in terms of providing a consistent strategy across the States but also giving States an opt-out should they be concerned that the standards have become too relaxed, the regulations have become too relaxed, and so on and so forth? Is there some compromise that would be important to kind of make sure we do not create a national regime and preempt States in a fashion that puts people at risk? Professor Coffee, is that something you might want to address?

Mr. COFFEE. I will certainly address it. I think Mr. Herstein would like to, also. I think you do need a compromise here, because I understand that a small issuer finds it burdensome to have to file with blue sky commissioners in 20 or 30 States, because the Internet is worldwide, and if you are going to follow up with an intermediary that is going to be making offers also by emails, that is going to be a national distribution.

Therefore, I think the answer is to have some sort of uniform limited exemption that the NASAA would agree upon. They have done that in the area of private placements with their uniform limited private placement exemption. I think they could do something similar here.

So I would urge you not to preempt any form of uniform limited exemption which could provide for a one-stop filing that you could file electronically and you would know that you were in compliance. There is very little burden there. And, ultimately—and I want to say this, you can endorse this or disagree, but I think that the blue sky commissioners would be the primary line of regulatory defense. If there is fraud, it is more likely to be found by the blue sky commissioner because these transactions, particularly under crowdfunding, will be so small to be largely below the SEC's radar screen. The SEC is, frankly, an overworked and underfunded agency. They have to prioritize. And I think these smaller offerings of a half million or so are more likely to be monitored and, if necessary, enforced by blue sky commissioners. So I do not want to have them fully preempted.

Senator MERKLEY. Mr. Chair, do I have time to continue this for a moment?

Chairman JOHNSON. Yes.

Senator MERKLEY. Thank you. Go ahead.

Mr. HERSTEIN. Thank you, Senator, and thank you, Professor Coffee. The States definitely look at preemption as a concern for them. They are small investors, small issuers, and they are in the States. In my written testimony that I gave, the States are currently working on a model rule which I think Professor Coffee described as basically a one-stop filing in the State that is the principal place of business for the crowdfunding issue. It would have basically limited filing requirements. Most of the items would be probably on their Web page. And the States are working on it, and the States can do this if the preemption cause is listed. And you talked about the mortgage problems. I will go back to 1996 when NSMIA was adopted. The States were taken out of reviewing Regulation D offerings or 506 offerings. Since that time, that has been the States' number one investigation problems. We have had more cases per year on investigating Regulation D frauds than any other fraud that comes along.

So preemption is on the mind of States. Once you take preemption away from the States, it is very difficult to get it back. We have been trying since 1996 to get Regulation D back, and we have not been successful. So definitely with the small issuers that deal with the States, we do not want to lose that preemption.

Senator MERKLEY. I have one more issue if we have time, but I will defer to my colleague.

Chairman JOHNSON. Take up the issue.

Senator MERKLEY. Thank you.

Mr. Cutler, I wanted to get a sense of one issue I have heard raised under raising the Regulation A limit, and that is, whether or not by going to a $50 million limit you have a path that could be created in which companies could get onto the New York Stock Exchange but never experience, if you will, the more detailed disclosure requirements that all companies on the New York Stock Exchange currently abide by. Have you explored that issue?

Mr. CUTLER. I think you have to remember that, should a company utilize the Regulation A offering, first of all, they would still be subject to the shareholder limitation requirements that already exist, and so they would have to be a regular reporting company under 12(g) to the extent that would be triggered. And the disclosure requirements that are currently in existence under Regulation A, while less than what is required under full registration, still require review and approval by the SEC in a document that is filed with the SEC, a much greater level of disclosure that is required certainly in any other private placement scenario. And so the amount of disclosure there is significantly greater than what you see in other areas.

Senator MERKLEY. In other words, the pathway is possible, but not one you are concerned about.

Mr. CUTLER. Well, again, I think in order for a company to obtain, I believe, exemption from all the State blue sky, you would still have to list on a national exchange and also qualify the quantitative listing requirements on either NYSE or Nasdaq to be able to qualify to list on that exchange and comply with all of the gov-

ernance requirements, were you to choose to list and trade on an exchange utilizing that offering.

Senator MERKLEY. Thank you.

Thank you, Mr. Chair.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman, and I appreciate this hearing, and I am sorry that I could not get here earlier since I was at the Senate Foreign Relations Committee where we were having a very spirited debate with the Administration on Iran sanctions, which we think is critical, a ticking time bomb that is on its way, and a vote that will take place later on the floor. But I am glad to have been able to get here because I think it is critical that small businesses have more access to capital and to create jobs and grow our economy. And I have been pursuing that in many different ways, and I am certainly open-minded to the different ways we can do that and glad we are exploring that today.

I am thrilled to welcome Mr. Gheysens to the Committee. As a fellow New Jerseyan, we appreciate you being here and sharing some insights.

I want to ask you, we have a series of different bills in the Senate to raise the fairly old 500-shareholder threshold for companies so that they can raise money for more shareholders before SEC registration kicks in. One of those bills applies just to banks, while another one applies to all companies.

My question to you would be: Why is the threshold important to companies other than banks like Wawa? And if, in fact, we did that, what would be your projection of the possibilities of how many more jobs Wawa would be able to create in New Jersey if that threshold was raised?

Mr. GHEYSENS. Thank you, Senator Menendez. So in terms of why this is important to private companies and not banks, if you will, a company like Wawa and other private companies have come up, have grown over the time when they have had flexibility under the laws, the 500-shareholder limit that has been in place since 1964. However, many have hit an inflection point where remaining private is still critical to their success, like Wawa, but going forward will be limited in their ability to grow because remaining private means dollar for dollar we would have to take capital dollars for new store growth and job creation away to be able to restrict and reduce the number of shareholders we have just to remain private under that outdated rule.

So, in particular, Wawa would have a one-time probably $40 million in our analysis reverse stock split that would be dollar for dollar away from new store growth.

Now, specifically in New Jersey, it would be tough for me to say where exactly those jobs would come from. New Jersey, as you know, today has 235 Wawa's, 7,200 associates that work just in the State of New Jersey, and has a significant amount of our growth planned going forward, as well our new market in Florida. So those two markets would be most significantly impacted. I would project several hundred jobs at Wawa in a one-time event would be lost—or not gained, if you will, through creation, and also other jobs around that we support through our vendor network and construction network.

Now, that just talks to a one-time event. If the rule is not updated over the long term, we will continue to have to reserve a significant amount of capital just to stay private, and I do not have those specific numbers. I can get back to you.

Senator MENENDEZ. Let me ask the other members of the panel, if we were to raise the threshold, how do we ensure that additional investors would be protected from fraud? Anybody have any ideas on that? Ms. Cross.

Ms. CROSS. I could weigh in on one point. I think one of the suggestions that is being discussed is to exclude employees from the count of shareholders in the up to 500, and I think that—I have some concern that if you exclude employees and do not otherwise provide them information, that if things went poorly at their company, they could both lose their job and their savings.

I think that if you look at Mr. Gheysens' written testimony, his company provides information to their employees, financial information about the company, quarterly and annually, and one possibility is to condition an exemption for excluding employees on requiring a company to provide information to the employees that would not have to be filed publicly, but at least so that the employees have a sense for how things are going at their employer, I think is one important thing to consider.

Senator MENENDEZ. Now, the House has addressed changing the 500-shareholder threshold for community banks and nonbanks in separate bills, and they have two different thresholds: one is 2,000 for banks, another one is 1,000 shareholders for nonbanks.

Does it matter to the SEC? Is there a greater ability to pursue, for example, under the single threshold that Toomey-Carper has for banks and nonbanks as well? Does it make a difference to you from a regulator's perspective?

Ms. CROSS. The Commission staff is currently doing their study of the Section 12(g) thresholds and how different companies would be impacted. I think that as it relates to banks, the analysis that has been put forward by proponents of having a separate test for them is that they have the call report information, which provides information to bank holders in a way that other unregulated companies do not. So that is certainly something that is relevant to the discussion, but the questions about, for example, whether companies are traded in a fashion that should require the public disclosure is probably a similar question both for banks and other companies. So I think that there is—we do not have a conclusion at this point on whether it should make a difference what kind of company it is, but there certainly are some arguments that could be made.

Senator MENENDEZ. Finally, if I may, Mr. Chairman, I know you were just here just less than a month ago on an unrelated topic. How are we doing on 953(b) of getting that provision pursued?

Ms. CROSS. We are drafting the release as we speak and working hard to get it done just as soon as we can.

Senator MENENDEZ. All right. Thank you very much.

Chairman JOHNSON. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. I thank all the witnesses. Sorry I was late as well.

There is a lot of focus on job creation, justifiably, get businesses growing again, so I am glad to see, Mr. Chairman, the Banking Committee is focusing on ways we can help.

We all know that our capital markets have really been a vital part of American job growth. American companies rely more on the capital markets than competitors in Europe or Asia, and as prior testimony has pointed out, the data shows that historically over 90 percent of job creation occurs post-IPO. But we all know the number of IPOs in the U.S. has been declining for some time, especially for small- and medium-sized businesses. So this morning I am introducing, along with colleagues on this Committee—Senators Toomey and Warner as well as Crapo, and I want to thank them for their help and support. We have introduced a bill that would accelerate that job creation by creating an on-ramp for small- and medium-sized businesses to go public and phasing in certain obligations over time as the companies grow.

The proposals in our bill were based on work done by the IPO Task Force. That is a group with a broad cross-section of representation—venture capitalists, entrepreneurs, lawyers, bankers, academics.

So my first question is for Mr. Cutler. In your testimony you refer to the on-ramp concept in our bill. You also discuss several other proposals floating around Congress that have been the subject of debate this morning. In your view, if Congress were to adopt one of the proposals to stimulate job creation, which of these proposals would do the most to encourage job creation?

Mr. CUTLER. Thank you, Senator Schumer, and I applaud your leadership on this issue and applaud the efforts to actually create legislation that addresses the biggest problem that has the potential to have the greatest impact on job creation, which is really addressing the problem of the hurdles of our public markets. I think it is important to note that this is, what has been proposed, not a rollback of regulation, and it is only impacting those companies that need it most at the time of capital formation in the public markets.

I give you the example of a company like LinkedIn that went public earlier this year. It has doubled its workforce in the last year after going public this year. Rack Space, a technology company that went public a few years ago, a 55-percent increase in growth.

And so we really think this has the greatest potential impact because you are also addressing the largest pool of liquidity that is available to these companies of anywhere in the world.

Senator SCHUMER. So you would choose our bill. And as you mentioned, do you think the bill—well, that is what he said. He just did not say it explicitly.

[Laughter.]

Senator SCHUMER. Would you choose our bill as the one that would do the most?

Mr. CUTLER. Of course, yes.

[Laughter.]

Mr. CUTLER. It is a fantastic piece of legislation.

Senator SCHUMER. Thank you. Now, let us try a second question and see if you can get to the point quicker. In your view, does our

bill strike a good balance between easing the burdens on small-company IPOs and protecting investors?

Mr. CUTLER. Yes. I think if you look——

Senator SCHUMER. Thank you.

[Laughter.]

Senator SCHUMER. I am only hurrying along because we have limited time. This is to Mr. Knight. In your testimony you allude to a phased-in approach for certain obligations similar to the approach we take in our bill. Do you support the proposals of the IPO Task Force and our bill and think they will help increase IPOs by growing companies and helping spur creation?

Mr. KNIGHT. Yes, sir. Absolutely.

Senator SCHUMER. Good. Thank you.

Next, Ms. Cross, I understand you are familiar with the IPO Task Force proposals, in particular the concept of creating an IPO on-ramp for small- and medium-sized families. Would you support any of these proposals or at least agree to work with my colleagues and me on the Committee to develop an on-ramp that will help companies access public markets while protecting investors?

Ms. CROSS. Well, first of all, of course I would agree to work with you and your colleagues. I have met with the IPO Task Force leaders, and they have some very thoughtful recommendations. There are some that I am particularly personally interested in, the ones—the on-ramp, the disclosure requirements.

I do want to note that some of the ideas do raise some important policy questions relating to the treatment of research reports and the research analyst rules which I think the Commission would be particularly interested in making sure do not tip the balance the wrong way on investor protection. But, yes, we would be, of course, happy to work with you.

Senator SCHUMER. OK. Thank you.

Mr. Herstein, do you support the concept of an IPO on-ramp?

Mr. HERSTEIN. In most cases, those——

Senator SCHUMER. I think you have to turn on your microphone.

Mr. HERSTEIN. Sorry, Senator. In a majority of those cases, those type of offerings would be exempt or preempted from the State filing requirements. But being a part of the SEC's Small Business Advisory Committee several years ago, one of our recommendations was to help small businesses basically on your on-ramp proposal.

Senator SCHUMER. Thank you.

And the last question is for Ms. Cross on a different subject, if I might, Mr. Chairman. It is about the Chinese audit firms and what the SEC is doing to ensure investors are protected, even though the PCAOB has not been able to examine Chinese audit companies. As you know, last week I wrote that organization to request they take disciplinary action to deregister Chinese audit firms that refuse to cooperate. This is a pattern we see with China everywhere. They just want different rules, and we sort of shrug our shoulders and say OK, and enough is enough.

In this one, the PCAOB operates under the oversight of the SEC, so I want to know what steps you have taken to get the PCAOB to do its job and inspect the China-based auditors or take enforcement action. How long are we going to let this stalemate with China go on?

Ms. CROSS. I appreciate the question. I think we also view this with some urgency and are working closely with the PCAOB to solve this problem. I cannot give you a date. I do not want to—our chief accountant's office is the one that is working the most closely with the PCAOB on this issue, but we also view it with some urgency. And the suggestion that I understood that you had raised about perhaps requiring disclosure so investors are at least aware of the lack of inspection I think is an interesting idea that we are certainly discussing internally right now.

Senator SCHUMER. OK. Thank you, Mr. Chairman. Thank you, Senator Reed, for——

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and let me apologize for my comings and goings, but we have a national defense bill on the floor and we have an appropriations bill that I am the chairman of the subcommittee.

Let me just go back to a question, I think, that was raised by several of my colleagues, and Professor Coffee, when we talk about raising the number of individual holders of stock to qualify for an exemption for securities laws, I interpreted or assumed from your answer we also have to look back at the notion of beneficial ownership, that if we do not fix both, we could have this situation where we raise it to X level, but, in fact, the number of people who actually hold the shares could be huge. So is that something that has to be done, in your view, sort of in parallel or together, otherwise, we just do not fix the problem?

Mr. COFFEE. I think you are summarizing the intent of my testimony. You just said it clearer. You can game, you can manipulate this, not only in terms of when you become a reporting company, but several of these bills allow companies, particularly banks, to deregulate, or "go dark" in the vocabulary, if they can get their number of shareholders of record below 1,200. If you let them escape the system, even though they are now making the disclosure, by getting the number below 1,200, they can pressure their shareholders to switch from record ownership to street name ownership, beneficial ownership in order to escape SEC oversight, and frankly, I will tell you, if they "go dark," bad things happen in the dark. Conflicts of interest do not get disclosed. Foreign Corrupt Practices Act gets escaped because you are no longer subject to it. I think you have got to solve this problem more or less simultaneously.

I am not against raising the level. Maybe it should be adjusted. But I think it has got to be a meaningful level that gives priority and protection to small issuers and does not allow large institutions to escape out the back door.

Senator REED. I would like for Ms. Cross to respond, also, but before I do that, one of the arguments with respect to banking holding companies is they are subject to significant financial regulation. But your response seems to suggest that that would not deal with a lot of the issues—Foreign Corrupt Practices Act, et cetera—and the fact that a lot of financial reporting is deliberately close held because they do not want to disclose proprietary information or many other reasons. So——

Mr. COFFEE. You have again summarized me better than I did. Bank regulation is looking at the solvency of the bank. SEC regula-

tion is looking at things like conflict of interest and the minority investors problems.

Senator REED. Thank you.

Ms. Cross, your comments in terms of the relationship between the number of owners and the notion of beneficial ownership and record ownership. It has to be done in tandem. And also any comments in terms of financial institutions in particular.

Ms. CROSS. Thank you. So the number of holders question and whether you should adjust both the number of record holders and require a look through to how many beneficial holders—that is is something that we think is a very important part of this conversation. If Congress adopts the legislation that is before it, that does not preclude the SEC from still going ahead and looking—and trying to decide how should we count, and in fact, one could look at the numbers that are in the bills and then decide, once you figure out how that translates in terms of beneficial owners, that it requires further adjustment because a change from 500 to 1,000 when it turns out that 1,000 is really 50,000 would result in a different policy call. So those are all things that the staff is helping the Commission consider.

Senator REED. Just a comment, given recent observations, is that there are some who have criticized Dodd-Frank for many different reasons, but so much discretion given to the SEC and then seeing some of the rules being voided by court appeals, by courts, by economic analysis, et cetera, that might argue if we are going to fix this, we should probably fix it in legislation rather than rely upon sort of the inherent rulemaking or the implicit rulemaking of SEC. That is just a comment.

If I can, again, Mr. Chairman, change the subject slightly, because Mr. Gheysens, you not only are a very articulate advocate for the company's position with respect to this legislation, but you run a business that is Main Street in every little community. I drive, particularly around here, I drive by them all the time. And we are currently engaged in a debate about an extension of unemployment benefits, et cetera. Do you have any sort of notion about the effects on the demand in a convenience store gas station operation like you if we do not do this? Are you anticipating a shock to your sales?

Mr. GHEYSENS. Senator, let me make sure I understand the question.

Senator REED. Yes.

Mr. GHEYSENS. So if unemployment benefits are not extended, what would be the impact——

Senator REED. Right.

Mr. GHEYSENS. I would only be speculating, but certainly the American consumer, as we have seen in our sales, is pinched. They are trading off and making decisions each and every day to make ends meet. Some of our business is discretionary. Some of our business, frankly, is not, in terms of gas. So I do not have a particular belief, but I would tell you, over what we have seen in the last several months, it would suggest that that could have a negative effect on our sales.

Senator REED. Thank you very much. That is a very fair and very thoughtful answer.

If I may take one more question, Mr. Chairman——

Chairman JOHNSON. Yes.

Senator REED. Let me go back to Professor Coffee. You also in your testimony, you talked about the increased use of Regulation D for private offerings. In fact, there was a suggestion that $320 billion was raised in the first quarter of 2011 alone and that it could put us on a trajectory for $1.2 trillion through—these are private offerings, which are, in some respects, a surrogate or a replacement for the IPO offerings, and these offerings were about a million dollars. So it seems to me that the markets are responding, at least in Regulation D, to the needs of small companies that are looking to get started. Can you comment?

Mr. COFFEE. I think the SEC's Chief Economist has estimated that between 2009 and maybe the middle of 2011, there were 37,000 Regulation D offerings and the median size was $1 million. That means that many issuers are choosing the private market route. I do not think that the SEC or Congress should tell the private issuer which way to go, private versus public. Make your own choice. You should make sure that both avenues are available and are both consistent with reasonable investor protection and issuers will choose what is best for them. So I think we have to recognize that Reg D is likely to be the main highway for lots of companies raising capital.

Senator REED. Can I ask one final question, and that is—you might not have the statistics, but one of the persistent criticisms of the regulatory structure is it is expensive, particularly when it comes to initial public offerings. Is there any sort of notion of what the compliance costs are in a public offering vis-a-vis the investment banking costs, I mean, the promotion costs, the advertising costs? If the actual compliance costs are relatively small, then the monetary deterrence of sort of public offering is not about regulatory, it is about other factors.

Mr. COFFEE. I know a number of studies of what the costs are both in going public and in remaining public in the first couple of years. If you look at the costs of remaining public after the IPO, the largest single cost is D&O insurance because you do not dare go public without insuring your board. That can be nearly a million dollars there.

Then you have costs for enhanced auditing. This is not 404. This is basically auditors charge more if you are a public company because they are afraid of getting sued. So that is significant.

There are costs for listing fees and there are some other costs, but I would have to say that the costs of 34 Act, of Securities and Exchange Act filing, would only be fourth or fifth on this list. That does not mean that we do not want to reduce those costs, but it is not one of the top three costs compared to things like D&O insurance or higher auditing costs.

Senator REED. But these costs, to be fair, are all related to the public status of the company?

Mr. COFFEE. Yes. And, first of all, when you do a public offering, you pay underwriters. Underwriters normally charge 6½ to 7 percent of the total offering price. It is a lot cheaper in private placements.

Senator REED. Thank you all very much. Thank you, Mr. Chairman. You are very kind.

Chairman JOHNSON. I would like to thank all of our witnesses for being here with us today. The testimony we have heard today will help the Committee in its important work of determining how best to help businesses sell stock to get needed capital while protecting investors. I am committed to help spur job growth as we help to take legislative action as quickly as possible and bipartisan solutions.

This hearing is adjourned.

[Whereupon, at 12:18 p.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON

Our Nation is facing an unemployment crisis. Nearly 14 million Americans are unable to find a job, and over 5 million have been unemployed for 6 months or longer. Here in Congress, putting our fellow Americans back to work should be, and must be, our top priority.

The American people are frustrated, and rightfully so, by a political system that is bogged down in partisan battles. However, our focus today is an issue where I believe there is real potential for bipartisan cooperation, and for results.

We are here to discuss how to help startups and businesses get access to the capital they need to grow and to create new jobs, while protecting investors.

Today, the Committee is pleased to hear testimony from three of our fellow senators as well as expert witnesses who will talk about challenges that businesses and entrepreneurs can face when attempting to raise money by selling stock.

The Committee will also hear about proposals and ideas that seek to improve existing securities laws. The witnesses will discuss the SEC's requirements for a person or company to sell securities to the public.

They will also provide insight on proposals to expand the scope of Regulation A offerings, to permit general solicitation of investors in Regulation D offerings, and to allow individuals to solicit and sell small amounts of stock over the Internet through crowdfunding.

They will address the size of a private offering and the amount of money that a crowdfunder should be able to risk without full regulatory protection. They will discuss the types of markets where these securities should trade. They will also describe the existing investors' safeguards, such as disclosures about the business and financials, and how current proposals would affect those safeguards.

In addition, witnesses will review the requirements for banks and other companies with 500 or more shareholders "of record" to register with the SEC, which requires important information to be provided regularly to shareholders, and discuss whether the transparency is important to investors and appropriate for different types and sizes of companies.

And additional ideas may be raised in the Committee's discussions. A recommendation that came up in a recent hearing, and which I have a strong interest in exploring, involves amending Regulation D to add American Indian tribes to the list of accredited investors.

I want to thank Senator Shelby and his staff for their cooperation in developing this hearing. I think we agree that firms that are in a position to grow will seek to raise more capital if the process of selling stock is made easier and less costly. If they succeed, this can lead to more jobs and economic prosperity. At the same time, investors must be willing to buy the stock that businesses offer, and they are more likely to do so when they have enough reliable information and know that they are not at risk of being scammed.

I look forward to the testimony of the witnesses and to working with my colleagues on both sides of the aisle to develop bipartisan legislative solutions that promote job growth and business expansion while protecting investors.

PREPARED STATEMENT OF SENATOR KAY BAILEY HUTCHISON

Good morning, Chairman Johnson and Ranking Member Shelby, and thank you for holding today's important hearing on proposals to support job creation through capital formation.

After serving on the Banking Committee during the last Congress, it is a pleasure to be back, even if on the other side of the dais, to speak in support of S. 556.

S. 556 is a common-sense bill with strong bipartisan support that will enable growth in our Nation's economy, while strengthening our community banking system.

I sponsored this legislation last year and again this year with my friend from Arkansas, Senator Pryor.

Our bill would foster capital formation in the community banking industry, and would allow community banks to bolster their balance sheets to meet the more stringent capital standards imposed by the Dodd-Frank Act.

This additional capital would free community banks to lend to creditworthy small businesses, who in turn can go out and do what we need them to do: invest in new operations and projects, create jobs, and give our Nation's economy a badly needed lift.

It is estimated that this measure could free banks to lend up to $800 million to American small businesses.

S. 556 would to update the threshold before a bank must register its securities with the Securities and Exchange Commission (SEC).

Under current law, any company with $10 million in assets and 500 shareholders is required to register its securities with the SEC.The $10 million asset size threshold has twice been increased since being enacted in 1964.

The 500-shareholder threshold, however, has never been changed.

For banks that exceed the 500 shareholder threshold, the high cost of complying with SEC reporting requirements consumes capital resources that could otherwise be used for lending.

Modernizing the shareholder threshold would allow banks to raise the additional capital they need to shore up reserves, and increase lending to worthy small businesses and families.

Community banks tell me that they could each save about $250,000 in costs to satisfy regulatory requirements if the shareholder threshold is raised to 2,000. Spread across the entire country, our bill would save community banks more than $80 million, which, when deployed as capital, could allow these banks to lend up to $800 million to American small businesses.

Community banks and small businesses form the backbone of our economy.

With just 11 percent of the banking industry's assets, community banks make nearly 40 percent of all loans to small businesses.

I welcome today's hearing on S. 556 and other bills to spur job creation through capital formation.

The bill that I am offering with Senator Pryor has strong bipartisan support. The House recently passed a companion bill by a vote 420 to 2. I am confident that the Senate would pass it in similarly overwhelming fashion if we put it to a vote.

SALVATORE MARRANCA
Chairman
JEFFREY L. GERHART
Chairman-Elect
WILLIAM A. LOVING, JR.
Vice Chairman
JACK A. HARTINGS
Treasurer
STEVEN R. GARDNER
Secretary
JAMES D. MACPHEE
Immediate Past Chairman
CAMDEN R. FINE
President and CEO

November 16, 2011

United States Senate
Washington, DC 20510

Dear Senator:

On behalf of the nearly 5,000 members of the Independent Community Bankers of America (ICBA), I write to urge your support for expeditious action on S.556. S. 556, sponsored by Senators Kay Bailey Hutchison (R-TX) and Mark Pryor (D-AR) would raise the threshold of bank shareholders that triggers Securities and Exchange Commission (SEC) registration from 500 to 2,000 and raise the deregistration threshold from 300 to 1,200. ICBA has promoted this important SEC reform for the community banking sector for many years. It has been part of the ICBA-backed legislation in previous Congresses. It is now included in an important community banking sector bill, S. 1600, the Communities First Act, recently introduced by Senator Jerry Moran (R-KS) in the 112th Congress. In a show of strong bipartisan support, on Wednesday, November 2, the House passed an identical SEC reform provision in legislation by a vote of 420 to 2.

This change would allow community banks to raise more equity capital without tripping the SEC registration requirement that brings with it very expensive regulatory compliance costs. S. 556 will help community banks better serve their customers and communities and contribute to the economic recovery.

The five hundred shareholder threshold has been law since 1964 when Section 12(g) was added to the Securities and Exchange Act of 1934 and has not been raised since that time. Community banks that register must comply with the same quarterly and annual reporting requirements, proxy solicitation, and insider trading requirements applicable to the very largest companies listed on an exchange. Registered companies are also subject to the Sarbanes-Oxley 404(a) requirement that management certify internal controls. Registration involves significant legal and accounting expenses for a small company of approximately $100,000 initially and $50,000 annually thereafter. The expense is disproportionately large for community banks because they do not have the scale of larger institutions to spread legal and compliance costs. Due to new requirements, such as SOX 404(a), these costs have increased significantly in real terms since 1964, altering the cost-benefit ratio which was the basis for the original threshold.

INDEPENDENT COMMUNITY BANKERS of AMERICA *The Nation's Voice for Community Banks.®*
1615 L Street NW, Suite 900, Washington, DC 20036-5623 ■ 800-422-8439 ■ FAX: 202-659-1413 ■ Email: info@icba.org ■ Website: www.icba.org

As bank regulators demand higher capital levels, community banks must be able to raise capital from more shareholders without SEC registration. Because community banks are subject to close regulatory scrutiny, the registration threshold can be raised without increasing investor risk.

Raising the SEC deregistration threshold from 300 to 1200 will make it easier for registered community banks to deregister following a stock buyback or consolidation of shareholders. A company that has registered should have a reasonable opportunity to deregister and reduce unproductive expenses.

Again, we urge your support for expeditious action on S. 556. It is long overdue and will help ensure that America's community banks have the capital they need to continue helping our nations' economic recovery.

Sincerely,
/s/
Camden R. Fine
President and CEO

INDEPENDENT COMMUNITY BANKERS of AMERICA The Nation's Voice for Community Banks.®
1615 L Street NW, Suite 900, Washington, DC 20036-5623 ■ 800-422-8439 ■ FAX: 202-659-1413 ■ Email: info@icba.org ■ Website: www.icba.org

November 30, 2011

To: Members of the United States Senate

Re: S. 556, to Amend the Securities Laws to Establish Certain Thresholds for Shareholder Registration

The American Bankers Association (ABA) and the undersigned state banker associations are writing to express our strong support for S. 556, bipartisan legislation introduced by Senator Kay Bailey Hutchison (R-TX) and Senator Mark Pryor (D-AR) to raise the shareholder threshold for Securities and Exchange Commission (SEC) registration.

Many banks have had to deal with the 500 shareholder rule, which has remained in place for more than 40 years without being updated, and which causes local-oriented banks to be subject to the same costly reporting requirements as large, public firms. Many banks that are nearing the 500 shareholder threshold have limited sources from which to raise the capital necessary to meet the credit needs of their communities without increasing the number of shareholders and triggering registration with the SEC. Once registered as public companies, banks, regardless of size, become subject to disproportionately high financial and opportunity costs when compared to other smaller public companies. These regulatory requirements and costs eat into capital and limit banks' ability to make loans in their communities.

Local financial institutions are part of a highly regulated industry governed by numerous statutes and regulations affecting almost every aspect of banking activity. Most banking institutions are regulated by two agencies: a primary federal regulator and, in the case of state-chartered banks, by the state regulator, as well. Significant financial and other information regarding every bank and savings association can be publicly viewed on the website maintained by the FDIC. All banks are required to make annual reports available to both their customers and investors. Most provide financial and other information to investors through their company websites.

The advantage to the local banks from increases in the registration and deregistration thresholds would not be a lack of transparency, since keeping shareholders and the public fully informed about a bank's performance is essential to its presence as a community bank. Rather, it is a reduction of regulatory burdens and reporting requirements that pose a disproportionate burden on small institutions.

S. 556 would update the registration threshold to 2,000 shareholders, a level that we strongly support. This change would enable banks to deploy their capital in lending rather than spending it on regulatory requirements that provide little incremental benefit to the banks, shareholders, or the public.

In addition, S. 556 addresses the threshold for deregistration, which can occur when the number of shareholders decreases and once-public businesses can become private. Currently, the number of shareholders of record must fall below 300 before a business can

deregister. Raising the threshold for deregistration to 1,200 along with the threshold for registration makes a lot of sense from both a business and corporate governance perspective.

We strongly support S. 556 and urge passage of this important bill to allow community banks to raise capital without adding regulatory burden.

Sincerely,

American Bankers Association
Alabama Bankers Association
Alaska Bankers Association
Arizona Bankers Association
Arkansas Bankers Association
California Bankers Association
Colorado Bankers Association
Connecticut Bankers Association
Delaware Bankers Association
Florida Bankers Association
Georgia Bankers Association
Hawaii Bankers Association
Heartland Community Bankers Association
Idaho Bankers Association
Illinois Bankers Association
Illinois League of Financial Institutions
Indiana Bankers Association
Iowa Bankers Association
Kansas Bankers Association
Kentucky Bankers Association
Louisiana Bankers Association
Maine Bankers Association
Maryland Bankers Association
Massachusetts Bankers Association
Michigan Bankers Association
Minnesota Bankers Association
Mississippi Bankers Association
Missouri Bankers Association
Montana Bankers Association
Nebraska Bankers Association
Nevada Bankers Association
New Hampshire Bankers Association
New Jersey Bankers Association
New Mexico Bankers Association
New York Bankers Association
North Carolina Bankers Association
North Dakota Bankers Association
Ohio Bankers League
Oklahoma Bankers Association
Oregon Bankers Association
Pennsylvania Bankers Association
Puerto Rico Bankers Association
Rhode Island Bankers Association
South Carolina Bankers Association
South Dakota Bankers Association
Tennessee Bankers Association
Texas Bankers Association
Utah Bankers Association
Vermont Bankers Association
Virginia Bankers Association
Washington Bankers Association
Washington Financial League
West Virginia Bankers Association
Wisconsin Bankers Association
Wyoming Bankers Association

PREPARED STATEMENT OF SENATOR MARK L. PRYOR

Chairman Johnson, Ranking Member Shelby, and Members of the Committee: Thank you for inviting me here today to discuss S. 556, a bill to amend the securities laws to establish a higher shareholder threshold for registration of banks as public companies. I also want to thank Senator Hutchison for her leadership on this important bipartisan bill.

Currently, the Securities Exchange Act requires a company with $10 million in assets and 500 shareholders to register its securities with the SEC and comply with the SEC's registration and reporting requirements. Since 1964, the original $1 million asset standard has been increased tenfold while the 500 shareholders of record requirement has never been updated.

I want to emphasize that our bill only changes the shareholder threshold for banks and not for other businesses. Banks are unique businesses because they are already highly regulated and have to maintain large dollar assets tied to their loans. Consequently, shareholder size is the only meaningful standard for whether a bank should be registered as a public company.

I have spoken with many community banks in Arkansas who are struggling to raise capital or expand their investor base. These community banks are increasingly subject to higher capital requirements due to the Dodd-Frank Act, Basel III rules, and banking regulator stress tests. Increasing their capital reserves will enable these banks to continue to serve and benefit their communities.

Increasing the shareholder limit would create an opportunity for community banks to bring in much needed new capital and increase lending. One dollar worth of capital supports up to $10 in loans. As banks approach the current shareholder threshold, they have to decide whether to go public or limit their access to capital. The result is that these banks are forced to make fewer loans in order to maintain their capital-to-assets ratio.

Today, a community bank with a small investor base is significantly different from what it was 40 years ago. While the shareholder threshold of 500 at one time may have been an accurate reflection of a public market, it no longer is today. It is time Congress updated this standard for banks. Thank you again for the opportunity to present this bill and I look forward to working with the Committee on its passage.

PREPARED STATEMENT OF MEREDITH CROSS

DIRECTOR, DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION

DECEMBER 1, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee: My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the Securities and Exchange Commission. I am joined in this testimony by Lona Nallengara, Deputy Director of the Division of Corporation Finance. We are pleased to testify today on behalf of the Commission on the topic of capital formation.[1]

The mission of the Securities and Exchange Commission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. A critical goal of the SEC is to facilitate companies' access to capital while at the same time protecting investors. Companies of all sizes need cost-effective access to capital to grow and develop, and the Commission recognizes that any unnecessary or superfluous regulations may impede their ability to do that. At the same time, the Commission must seek to ensure that investors have the information and protections necessary to give them the confidence they need to invest in our markets. Investor confidence in the fairness and honesty of our markets is critical to the formation

[1] Ms. Cross's participation in this testimony does not include matters related to crowdfunding. Prior to joining the Commission staff in June 2009, Ms. Cross served as counsel to a company in connection with its registration under the Securities Act of 1933 of notes offered and sold through its "peer-to-peer" lending platform. Although Ms. Cross has no financial or other interest in her former client or her prior employer, in light of the small number of participants in that market, in order to avoid any appearance concerns, she does not participate in matters involving peer-to-peer lending. Further, since there are some similarities between peer-to-peer lending and some crowdfunding concepts, even though Ms. Cross has been advised by SEC Ethics Counsel that there is no conflict of interest, Ms. Cross has determined that in order to avoid any appearance concerns, she will no longer participate in crowdfunding matters. For purposes of this written testimony, Mr. Nallengara is addressing crowdfunding matters.

of capital, and the protections provided by the securities laws are critical to large and small company investors alike.

Over the years the SEC has taken significant steps, consistent with its investor protection mandate, to facilitate capital-raising by companies of all sizes and to reduce burdens on companies making offerings, be it through introducing or increasing eligibility for shelf registration or implementing small business reforms. Going forward, the Commission will continue to consider and, if appropriate, implement changes to its existing rules to reduce regulatory burdens while maintaining important investor protections provided under the securities laws.

Chairman Schapiro has instructed the staff to take a fresh look at some of our offering rules to develop ideas for the Commission to consider that may reduce the regulatory burdens on small business capital formation in a manner consistent with investor protection. The staff's review is ongoing and is focusing on a number of areas, including:

- the number of shareholders and other triggers for public reporting;
- the restriction on general solicitation in private offerings; and
- restrictions on communications in public offerings.

Additional areas of review concern the regulatory questions posed by new capital raising strategies, such as crowdfunding, and the scope of our existing rules that provide for capital raising, such as Regulation A.

Additionally, the Commission's recently formed Advisory Committee on Small and Emerging Companies will provide the Commission and the staff with advice and recommendations about regulations that affect privately held and publicly traded small and emerging businesses.[2] The members of the Advisory Committee include representatives from a range of small and emerging companies, and investors in those types of companies, with real world experience under our rules. The Advisory Committee held its first meeting on October 31, 2011, where it considered a number of issues related to capital formation for small and emerging companies, including the triggers for registration and public reporting and suspension of reporting obligations, possible scaling of regulations for newly public companies, crowdfunding, possible modifications to Regulation A, and the restrictions on general solicitation.[3] We understand that the Advisory Committee intends to provide preliminary recommendations to the Commission on many of these topics in the coming weeks, and we are looking forward to receiving these recommendations.

My testimony today will focus on small business capital formation initiatives and the broader capital formation regulatory review we are undertaking at Chairman Schapiro's request.

Update on Review of Certain Offering Regulations

I would first like to provide an update on the staff's review of our regulations relating to the triggers for public reporting, the restrictions on general solicitation, and communications in connection with public offerings.

Triggers for Public Reporting

Chairman Schapiro has asked the staff to review the triggers for public reporting and the characteristics of companies that should be subject to public reporting obligations. In addition, bills have been proposed in both the House and the Senate relating to the Section 12(g) thresholds for reporting.

Section 12(g) of the Exchange Act, which sets forth certain registration requirements for securities, was adopted in 1964 following a rigorous special study of the securities markets in the early 1960s, commissioned by Congress and conducted by the Commission.[4] The study included a survey of over 2,000 issuers that sought

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[2] *See,* SEC Announces Formation of Advisory Committee on Small and Emerging Companies (Sept. 13, 2011), *http://www.sec.gov/news/press/2011/2011-182.htm.*

[3] *See,* SEC Advisory Committee on Small and Emerging Companies To Hold First Meeting on Oct. 31 (Oct. 13, 2011), *http://www.sec.gov/news/press/2011/2011-207.htm;* SEC Announces Agenda for First Meeting of Advisory Committee on Small and Emerging Companies (Oct. 25, 2011), *http://www.sec.gov/news/press/2011/2011-222.htm.*

[4] Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 88-95, pt. 3 (1963). According to the Committee Report summarizing the results of the study: "There is no convincing reason why the comprehensive scheme of disclosure that affords effective protection to investors in the exchange markets should not also apply in the over-the-counter market. . . . [B]ecause the over-the-counter market includes not only securities of widely known and seasoned companies but also those of relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great, if not greater than in the exchange markets." [S. Rep. No. 88-379, at 9 (1963)]

data from these issuers on, among other things, asset levels, their securities offerings, shares outstanding, stockholders of record, and the number of shares held by large shareholders. The data derived from the study was critical in developing metrics upon which to base the triggers for public reporting given the nature of the companies and the shareholders that would be impacted.

Section 12(g) requires a company to register its securities with the Commission, within 120 days after the last day of its fiscal year, if, at the end of the fiscal year, the securities are "held of record" by 500 or more persons and the company has "total assets" exceeding $10 million.[5] Shortly after Congress adopted Section 12(g), the Commission adopted rules defining the terms "held of record" and "total assets."[6] The definition of "held of record" counts as holders of record only persons identified as owners on records of security holders maintained by the company, or on its behalf, in accordance with accepted practice. As such, this definition simplified the process of determining the applicability of Section 12(g).[7]

Of course, securities markets have changed significantly since the enactment of Section 12(g) and the Commission's adoption of the definition of "held of record." Today, the vast majority of securities of publicly traded companies are held in nominee or "street name" rather than directly by the owner. This means that the brokers that purchase securities on behalf of investors typically are listed as the holders of record. One broker may own a large position in a company on behalf of thousands of beneficial owners, but because the shares are all held in street name, those shares count as being owned by one "holder of record." This change in the way securities are held 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. This has required private companies that have more than $10 million in total assets and that cross the 500 record holder threshold—where the number of record holders is actually representative of the number of shareholders—to register and commence reporting. At the same time, it has allowed a number of public companies, many of whom likely have substantially more than 500 beneficial owners, to stop reporting, or "go dark," because there are fewer than 500 "holders of record" due to the fact that the public companies' shares are held in street name. In light of these issues, some have called for changes to the definition and threshold adopted pursuant to Section 12(g).

The Commission has exercised its exemptive authority in the past to adjust the application of Section 12(g).[8] For example, in 2007, the Commission adopted Rule 12h-1(f) under the Exchange Act, which provides an exemption from the held of record threshold for compensatory stock options. This exemptive rule allows private companies to provide compensatory stock options to employees, officers, directors, consultants and advisors without triggering the need to register those options under the Exchange Act.[9] A variety of proponents have advanced a wide range of proposals relating to possible amendments to Section 12(g) reporting standards. Some of these proposals seek to limit the class of issuers required to report pursuant to the Exchange Act, for example, by raising the shareholder threshold,[10] by excluding

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[5] *See,* Exchange Act §12(g)(1); Exchange Act Rule 12g-1. When Section 12(g) was enacted, the asset threshold was set at $1 million. The asset threshold was most recently increased by rule to $10 million in 1996. Release No. 34-37157, Relief from Reporting by Small Issuers (May 1, 1996), *http://www.sec.gov/rules/final/34-37157.txt.*

[6] *See,* Release No. 34-7492, Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934 (January 5, 1965).

[7] *See, id.*

[8] Exchange Act Section 12(h) provides the Commission broad authority to exempt issuers from the registration requirements of Section 12(g) so long as the Commission finds that the action is not inconsistent with the public interest or protection of investors. The Commission has previously relied on Section 12(h) to raise the total assets threshold. Additionally, Congress has provided the Commission broad exemptive authority in Section 36 of the Exchange Act. The Commission has previously established exemptions from the Section 12(g) requirement and Section 12(g) provides the Commission with authority to define the terms "held of record" and "total assets." *See,* Exchange Act Rule 12g3-2 and Exchange Act §12(g)(5).

[9] Release No. 34-56887, Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934 (December 3, 2007), *http://www.sec.gov/rules/final/2007/34-56887.pdf.* The staff of the Division of Corporation Finance also issued a no-action letter saying that it would not recommend an enforcement action to a company that issued restricted stock units due to the similarities between them and stock options. *See,* Twitter, Inc. (September 13, 2011); Zynga Inc. (June 17, 2011); Facebook, Inc. (October 14, 2008).

[10] In a November 12, 2008, letter, the American Bankers Association made the argument that the 500-shareholder threshold should be increased to reduce the regulatory hardship suffered

employees, or by excluding accredited investors, qualified institutional buyers (QIBs) or other sophisticated investors from the calculation.[11] Conversely, the Commission has received a rulemaking petition requesting that the Commission revise the "held of record" definition to look through record holders to the underlying beneficial owners of securities that would prevent issuers from ceasing to report in certain circumstances.[12]

As stated, the securities markets have gone through profound changes since Congress added Section 12(g) to the Exchange Act. To facilitate the Commission's review of the issues related to the thresholds for public reporting (and those for leaving the reporting system), the staff is undertaking a robust study like the one conducted when Section 12(g) was enacted. The study is seeking to determine whether the current thresholds and standards effectively implement the Exchange Act registration and reporting requirements and what it means to be a "public" company such that an issuer should be required to register its securities and file with the Commission. The staff has begun a detailed analysis of public company information—including numbers of record and beneficial owners, total assets, and public float—to assess the characteristics of public companies. The study also will seek to obtain and consider private company information to assess current reporting thresholds. In connection with the study the staff expects to seek comment and data from companies, investors, financial market participants, academics, regulators and others on a number of the issues related to the current triggers for public reporting. To the extent that the staff develops recommendations or proposals regarding changes to the reporting thresholds for the Commission's consideration, the consequences of any such proposed change will be subject to careful assessment as to the impact on investor protection and capital formation and the other costs and benefits of any proposed change.

Restriction on General Solicitation

Chairman Schapiro also asked the staff to review the restrictions our rules impose on communications in private offerings, in particular the restrictions on general solicitation. In addition, legislation has been introduced which would require the Commission to revise its rules to permit general solicitation in offerings under Rule 506 of Regulation D.

One of the most commonly used exemptions from the registration requirements of the Securities Act is Section 4(2), which exempts transactions by an issuer "not involving any public offering." Currently, an issuer seeking to rely on Section 4(2) is generally subject to a restriction on the use of general solicitation or advertising to attract investors for its offering.[13] The restriction was designed to protect those who would benefit from the safeguards of registration from being solicited in connection with a private offering.

The Commission and staff have acted to provide increased certainty in connection with private offerings by adopting safe harbor rules, such as Rule 506, and providing guidance with respect to the scope of Section 4(2) and the restriction on general solicitation and advertising. Recognizing the increased use of the Internet and other modern communication technologies in private offerings, the staff has issued no-action letters providing issuers with flexibility to use modern communication technologies without the staff recommending enforcement action regarding the general solicitation restriction.[14]

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by small community banks. *See,* Comment Letter from American Bankers Association to SEC (November 12, 2008), *http://www.sec.gov/rules/petitions/4-483/4483-21.pdf.*

[11] *See,* 2009 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (May 2010), *http://www.sec.gov/info/smallbus/gbfor28.pdf.*

[12] On February 24, 2009, the Commission received a rulemaking petition urging the Commission to count beneficial owners instead of record holders to prevent companies with large numbers of holders from exiting the reporting system. *See,* Petition from Lawrence Goldstein to SEC (February 24, 2009), *http://www.sec.gov/rules/petitions/2009/petn4-483-add.pdf.* This followed an earlier, similar petition. *See,* Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities (July 3, 2003), *http://www.sec.gov/rules/petitions/petn4-483.htm.*

[13] *See,* Rule 502(c) of Regulation D and Release No. 4552, Non-Public Offering Exemption, (November 6, 1962).

[14] *See, e.g.,* IPONET (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a Web-based generic questionnaire and are provided access to private offerings via a password-protected Web site only if a broker-dealer makes a determination that the investor is accredited under Regulation D); Lamp Technologies, Inc. (May 29, 1998) (posting of information on a password-protected Web site about offerings by private investment pools, when access to the Web site is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D).

Notwithstanding these efforts, the restriction on general solicitation is cited by some as a significant impediment to capital raising.[15] We understand that some believe that the restriction may be unnecessary because offerees who might be located through a general solicitation but who do not purchase the security, either because they do not qualify under the terms of the exemption or because they choose not to purchase, would not be harmed by the solicitation.[16] In addition, some have questioned the continued practical viability of the restriction in its current form given the presence of the Internet and widespread use of electronic communications. At the same time, others support the restriction on general solicitation on the grounds that it helps prevent securities fraud by, for example, making it more difficult for fraudsters to find potential victims or unscrupulous issuers to condition the market.[17]

We believe it is important to consider both of these views about the need for the restriction on general solicitation in private offerings when considering possible revisions to our rules. In analyzing whether to recommend changes to the restriction, the staff is preparing a concept release for the Commission's consideration, through which it would seek the public's input on the advisability and the costs and benefits of retaining or relaxing the restrictions on general solicitation. The Commission could seek views from all interested parties on a number of issues related to the restriction on general solicitation, including specific protections that could be considered if the restriction is relaxed and the types of investors who would be most vulnerable if it is relaxed. Of course, in considering whether to recommend that the Commission make changes to the rules restricting general solicitation, we will remain cognizant of our investor protection mandate.

Communications in Public Offerings

We also are assessing our rules, and the regulatory burdens they impose, with respect to communications in public offerings. Over the years, the Commission has taken steps to facilitate continued communications around public offerings. For example, as early as 1970, the Commission adopted safe-harbor exemptions to make it clear that continued analyst research coverage does not constitute an unlawful offer.[18] In 2005, the Commission significantly reformed the registration and offering process by adopting a comprehensive set of rules and amendments to facilitate capital raising and relax restrictions on communications by issuers during the registered offering process.[19] These changes significantly liberalized the rules governing communications by the largest issuers during public offerings, thereby allowing more information to reach investors. The staff is reviewing the rules relating to communications in public offerings to consider whether any of the liberalizations adopted in 2005 should be adapted for smaller public companies, including whether more companies should be able to use free writing prospectuses before a substantially complete prospectus is filed. As a result of this review, the staff may recommend proposed changes to the offering rules, or recommend that the Commission seek additional input through the issuance of a concept release.

As part of its review, the staff also is considering regulatory questions posed by new capital raising strategies, such as crowdfunding, and the scope of our existing rules that provide for capital raising, such as Regulation A.

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[15] *See, e.g.,* Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (April 23, 2006), *http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf;* Joseph McLaughlin, "How the SEC Stifles Investment—and Speech", the *Wall Street Journal* (February 3, 2011). Concerns about the scope of the Commission's rules on general solicitation and advertising have been raised by the participants in the annual SEC Government-Business Forum on Small Business Capital Formation. *See,* 2010 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report (June 2011), *http://www.sec.gov/info/smallbus/gbfor29.pdf.*

[16] *See, Pinter v. Dahl,* 486 U.S. 622, 644 (1988) ("The purchase requirement clearly confines §12 liability to those situations in which a sale has taken place. Thus, a prospective buyer has no recourse against a person who touts unregistered securities to him if he does not purchase the securities.").

[17] *See, e.g.,* J. William Hicks, Exempted Transactions Under the Securities Act of 1933 §7:160 (2d ed. 2002); Comment Letter from Investment Companies Institute to SEC (October 9, 2007), *http://www.sec.gov/comments/s7-18-07/s71807-37.pdf* (warning that unlimited general solicitation would "make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes").

[18] *See,* Release No. 33-5101, Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933 (November 19, 1970).

[19] *See,* Release No. 33-8591, Securities Offering Reform (July 19, 2005), *http://www.sec.gov/rules/final/33-8591.pdf.*

Crowdfunding—A New Capital Raising Strategy

A new method of capital raising that is gaining increasing interest is crowdfunding. Generally, the term "crowdfunding" is used to describe a form of capital raising whereby groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal. This funding strategy was initially developed to fund such things as films, books, music recordings, and charitable endeavors. At that time, the individuals providing the funding were more akin to contributors than "investors" and were either simply donating funds or were offered a "perk," such as a copy of the related book. As these capital raising strategies did not provide an opportunity for profit participation, initial crowdfunding efforts did not raise issues under the Federal securities laws.

Interest in crowdfunding as a capital raising strategy that could offer investors an ownership interest in a developing business is growing. Bills have been introduced that would provide an exemption from Securities Act registration for securities sold in crowdfunding transactions that meet specified requirements. Proponents of crowdfunding are advocating for exemptions from the Securities Act registration requirements for this type of capital raising activity in an effort to assist early stage companies and small businesses. For example, the Commission received a rulemaking petition requesting that the Commission create an exemption from the Securities Act registration requirements for offerings with a $100,000 maximum offering amount that would permit individuals to invest up to a maximum of $100.[20]

The staff has been discussing crowdfunding, among other capital raising strategies, with business owners, representatives of small business industry organizations, and State regulators. For example, crowdfunding was discussed at the first meeting of the Advisory Committee on Small and Emerging Companies on October 31, 2011, and at the Commission's most recent annual Forum on Small Business Capital Formation on November 17, 2011. In January, the staff met with a group from the Small Business & Entrepreneurship Council advocating an exemption from registration requirements for crowdfunding offerings meeting specific requirements. In addition, in March the staff discussed crowdfunding with representatives from the North American Securities Administrators Association, the organization of State securities regulators.

Current technology allows small business owners to easily access a large number of possible investors across the country and throughout the world as a source of funding to help grow and develop their businesses or ideas. This source of capital and the ease with which an individual can communicate with and access investors electronically presents an opportunity for smaller companies in need of funds.

At the same time, of course, an exemption from registration and the investor protections provided thereby also would present an enticing opportunity for the unscrupulous to engage in fraudulent activities that could undermine investor confidence.[21] As a result, in considering whether to provide an exemption from the Securities Act registration requirements for capital raising strategies like crowdfunding, the Commission needs to be mindful of its responsibilities both to facilitate capital formation and protect investors.

The Commission's rules previously included an exemption, Rule 504, which allowed a public offering to investors (including nonaccredited investors) for securities offerings of up to $1 million, with no prescribed disclosures and no limitations on resales of the securities sold.[22] These offerings were subject only to State blue sky regulation and the antifraud and other civil liability provisions of the Federal securities laws. In 1999, that exemption was significantly revised due in part to investor protection concerns about fraud in the market in connection with offerings conducted pursuant to this exemption.[23] In assessing any possible exemption for

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[20] Petition from Sustainable Economies Law Center to SEC (July 1, 2010), *http://www.sec.gov/rules/petitions/2010/petn4-605.pdf.* To date, the petition has received almost 150 comment letters, all in favor of the creation of such an exemption, with some offering different thresholds for offering size and/or individual investment limits. The comment letters are available at *http://www.sec.gov/comments/4-605/4-605.shtml.*

[21] Note that the antifraud provisions of the Federal securities laws continue to apply to any offering or sale of securities, even if an exemption from registration applies. In Fiscal Year 2010, offering frauds—cases where promoters, issuers or others defraud investors in the offer of securities—comprised 22 percent of the Commission's cases.

[22] *See,* Release No. 33-6949, Small Business Initiatives (July 30, 1992), *http://www.sec.gov/rules/final/6949.txt.*

[23] *See,* Release No. 33-7644, Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption (February 25, 1999), *http://www.sec.gov/rules/final/33-7644.txt* (referencing "disturbing developments" in, among other things, initial Rule 504 issuances).

crowdfunding, it would be important to consider this experience and build in investor protections to address the issues created under the prior exemption.

Some of the questions to consider with regard to crowdfunding include:

- what limitations should be placed on the aggregate amount of funds that can be raised by a company and invested by an individual;
- what information—for example, about the business, the planned use of funds raised, and the principals, agents, and finders involved with the business—should be required to be available to investors;
- how and to what extent should Web sites that facilitate crowdfunding investing be subject to regulatory oversight;
- what restrictions should there be on participation by individuals or firms that have been convicted or sanctioned in connection with prior securities fraud;
- should a Commission filing or notice be required so that activities in these offerings could be observed; and
- should securities purchased be freely tradable?

Although the business venture may have a well-formulated plan and a committed entrepreneur, potential investors may have little information about the plan, its execution, or the entrepreneur behind the business. Investments in small businesses can be open to opportunism created by this information asymmetry. Although sophisticated investors with sufficient bargaining power may be able to negotiate protections for themselves in privately negotiated transactions, that opportunity is unlikely to be available in the crowdfunding context. Due to the nature of crowdfunding ventures, crowdfunding investors may have limited investment experience, limited information upon which to make investment decisions, and almost no ability to negotiate for protections. While the small amount of any crowdfunding investment may limit the extent of an individual's potential losses from any single investment, such losses may nevertheless be significant to the affected individual. These issues are among those that would need to be considered as a part of the cost-benefit analysis that the Commission would consider in connection with any future proposal.

Potential Increase in Offering Amount Permitted Under Regulation A

Regulation A under the Securities Act provides an exemption from registration for transactions by nonreporting companies of up to $5 million per year. The exemption requires an offering document to be filed with the SEC, which is subject to SEC staff review. The exemption sets forth information requirements that are simpler than those required in registered offerings, including allowing companies to provide the disclosure in a question and answer format, and allows companies to "test the waters" for interest in their offerings before they incur the full expense of preparing the Regulation A offering document. Unlike the private placement exemption, the Regulation A exemption permits a public offering that is not limited to particular types of investors, and the securities purchased are not transfer-restricted under the Securities Act. Unlike registered offerings, companies that complete Regulation A offerings do not automatically become subject to ongoing reporting under the Exchange Act. Instead, reporting would be required only if the company has a class of securities listed on a national securities exchange or the company reaches the thresholds under Section 12(g) that require registration under the Exchange Act. Offerings conducted in reliance on Regulation A are not preempted from State registration under Section 18 of the Securities Act, and, thus, are subject to compliance with State securities laws in the States in which the company offers or sells the securities.

Regulation A is not widely used. For example, in the fiscal year ended September 30, 2010, there were 25 initial Regulation A filings with the Commission and only three Regulation A offerings were qualified. Some have indicated that the $5 million annual cap reduces the utility of the Regulation A exemption and have advocated for an increase. The Regulation A offering limit was last raised in 1992, when it was increased from $1.5 million to $5 million.[24] Others have noted the lack of State preemption, requiring issuers and intermediaries to qualify offerings under Regulation A in each State under applicable blue sky laws. Bills have been introduced in both the Senate and the House that would require the Commission to create a new

[24] Regulation A was promulgated pursuant to Section 3(b) of the Securities Act, which allows the Commission to adopt rules exempting certain offerings, up to $5 million, if the Commission finds that "enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering . . . ."

exemption, which would be similar to Regulation A, but with certain additional conditions and a higher offering limit.

The ongoing review of the impact of our regulations on small business capital formation will include consideration of whether the Regulation A ceiling should be raised, including whether raising the ceiling would promote increased reliance on the exemption in a manner consistent with investor protection, and whether there are other impediments to use of the exemption that could be addressed by the Commission.

Conclusion

In considering possible revisions to the Commission's rules, it is critically important that the staff gather data and seek input from a wide variety of sources, including small businesses, investor groups, and other members of the public. The data and input the staff receives should aid in the development of thoughtful recommendations for the Commission consistent with the goals of facilitating capital formation and protecting investors.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF JACK E. HERSTEIN

PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

DECEMBER 1, 2011

Introduction

Good morning Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I'm Jack Herstein, Assistant Director of the Nebraska Department of Banking and Finance, Bureau of Securities and President of the North American Securities Administrators Association, Inc. (NASAA). NASAA is the association of State and provincial securities regulators.

State securities regulators have protected Main Street investors for the past 100 years, longer than any other securities regulator. State securities regulators continue to focus on protecting retail investors more so than any other regulator. Our primary goal and mission is to act for the protection of investors, especially those who lack the expertise, experience, and resources to protect their own interests.

The securities administrators in your home States are responsible for enforcing State securities laws by pursuing cases of suspected investment fraud, conducting investigations of unlawful conduct, licensing firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, and providing investor education programs and materials to your constituents.

Ten of my colleagues are appointed by State Secretaries of State; five are under the jurisdiction of their States' Attorneys General. Some are appointed by their Governors and Cabinet officials. Some, like me, are employed by State government departments or State agencies. Others work for independent commissions or boards.

States are the undisputed leaders in criminal prosecutions of securities violators. In 2010 alone, State securities regulators conducted more than 7,000 investigations, leading to nearly 3,500 enforcement actions, including more than 1,100 criminal actions. Moreover, in 2010, more than 3,200 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to State action.

Investor Protection and Job Creation

State securities regulators are acutely aware of the present economic environment and its effects on job growth.

In Nebraska, I see and also hear about the recession's lingering impact on small business on a daily basis and these effects can be devastating. Neither I nor any other State securities regulator seeks to inhibit economic growth through regulation that is overly burdensome or restrictive. To the contrary, Nebraska and other States are committed to fostering responsible job growth through capital formation because we believe small businesses are indispensable to a strong economy.

At the same time, as a securities regulator, I have for 34 years observed the profound and negative consequences of securities fraud and undisclosed investment risks on individuals and families, and on healthy and functional markets.

In much the same way small business investment has the potential to be a very positive economic force and a major driver of wealth and jobs when done in the right way, such investment also has the potential to become a costly failure that undermines market health and discipline, and places middle income investors at an extreme risk if done without appropriate oversight. The key is balancing the legiti-

mate interests of investors with the legitimate goals of entrepreneurs, and pursuing policies that are fair to both.

The success of small business is, in many respects, America's success, and one of the things we will need to do to get America moving forward again is to encourage small business growth and entrepreneurship. In the midst of a prolonged period of high unemployment and slow economic growth, this appeal grows even stronger. Many of us have seen businesses disappear since the financial crisis, not due to the inability to compete, or due to shortcomings in their business plan or the goods and services they produce, but due to their inability to get loans from banks.

The challenge for Congress today is to find policies that achieve the right balance between the objectives of promoting investment in valid business opportunities and protecting investors. Finding the right balance may be difficult, but the States stand ready to work with Congress and the SEC to ensure that this balance is achieved.

Principles for the Regulation of Small Business Investment

Before I discuss specific proposals pending before the Committee, I want to outline the several overarching principles that inform NASAA's thinking in this important area.

First, Congress should refrain from preempting State law. Preempting State authority is a very serious step and not something that should be undertaken lightly or without careful deliberation, including a thorough examination of all available alternatives.

Securities regulation is a complementary regime of both State and Federal law. Several of the proposals under consideration by Congress would needlessly and capriciously preempt State law. The exact opposite is better public policy. A decrease of Federal regulation in this area may be appropriate, but the States should continue to have the authority and flexibility to provide appropriate oversight because small business capital formation is a matter of grave concern at the State level. State securities regulators have no interest in throwing up needless roadblocks for small businesses. In fact, we are interested in creative ways to spur economic development and job creation.

Second, while Congress' desire to facilitate access to capital for new and small businesses is warranted, it must be sure do so in a careful and deliberate fashion.

Expanded access to capital markets is beneficial only insofar as investors remain confident that they are protected, transparency in the marketplace is preserved, and their investments are legitimate. Such assurances promote investor confidence, which is the key to the growth that Congress wants to encourage. If investors have no faith that small business offerings are being regulated to their satisfaction, they will be unlikely to invest their capital in these companies, and our efforts to facilitate growth through providing additional avenues of capital formation by small business will be in vain.

Third, Main Street investors should not be treated as the easiest source of funds for the most speculative business ventures. The law should not provide lesser protections to the investors who can least afford to lose their money.

Some of the proposed legislation before the Committee would give unproven companies direct access to small, unsophisticated investors without being required to provide the normal types of financial and risk disclosures. If a company cannot get financing from a bank, an SBA loan, a venture capital fund, or even friends and family, it is probably because there is a significant risk that the investment is extremely risky. The critical questions are: Have these sources stopped funding small businesses? If so, why?

The answers to these questions should dictate the universe of proposals Congress should entertain.

If the answer is that funding is not available because banks are not lending as they should, or because traditional sources of small business capital are unavailable even to well-qualified, established, or very promising small business endeavors, then this has the potential to stifle small business growth and hurt the economy. Therefore, Congress might consider certain steps to minimize or remediate this needless loss of productivity.

On the other hand, if the answer is that traditional sources of small business capital have reviewed the particular small business applicant and determined that the risk is too great, then we should not allow that applicant to seek investment from unsophisticated, "mom and pop" investors without appropriate investor protections. The typical retail investor, unlike the traditional small business financier, does not have the ability to conduct a reasonable investigation of a start-up or development-stage entity.

NASAA Comments on Specific Legislation Pending Before the Senate

In addition to the general priorities I articulated a moment ago, NASAA offers the following observations and suggestions regarding several bills that are now pending before the Senate and the Committee on Banking, Housing, and Urban Affairs.

I. Establishment of a Registration Exemption for "Crowdfunding" Securities (H.R. 2930, S. 1791)

Several bills recently introduced in the House and Senate would create a registration exemption for securities offerings made by "crowdfunding." Because there are important distinctions between each of these bills, I believe it is appropriate for NASAA to comment on them individually.

The Entrepreneur Access to Capital Act (H.R. 2930)

On November 3rd, 2011 the House of Representatives voted to pass H.R. 2930, the Entrepreneur Access to Capital Act, in a remarkable seven weeks after its introduction on September 14. The bill would create a new exemption from SEC registration for an offering amount up to $2 million ($1 million if the company does not have audited financial statements), with a maximum of $10,000 per investor (or 10 percent of the investor's annual income). The bill would treat these offerings as "covered securities" thereby preempting State authority to register the securities.

If this legislation is enacted in its current form, it will prohibit States from enforcing laws designed to minimize the risks to investors. By expressly preempting State law for the new crowdfunding exemption created under the legislation, it leaves a massive hole in the investor protection safety net. One of the fundamental tenets of securities law is that an investor is protected when the seller of securities is required to disclose sufficient information so that an investor can make an informed decision. Post-sale antifraud remedies provide little comfort to an investor who has lost a significant sum of money that is unrecoverable. This is a fundamental concern that States have had with H.R. 2930 since its introduction.

NASAA recognizes the need for small businesses to access capital in innovative ways that reflect modern realities, but we believe the exemption that would be established by H.R. 2930 is far too broad. The thresholds for individual investment and aggregate offerings set by H.R. 2930 are far higher than those sought by most advocates of crowdfunding and, as a result, small investors are exposed to the danger of considerable losses in these highly risky investments. A 2009 survey by the Employee Benefits Research Institute indicated that 53 percent of American households had less than $25,000 in total savings and investments,[1] so a $10,000 loss would be crippling to these households.

The Democratizing Access to Capital Act (Senator Scott Brown–S. 1791)

The Democratizing Access to Capital Act differs from H.R. 2930 in several important respects. First, under S. 1791, individual investments in crowdfunding are limited to $1,000 per person, per year, with an aggregate offering cap of $1 million. In addition, S. 1791 provides that in order to raise money through crowdfunding under a Federal exemption, the entity raising the money must be incorporated under, and subject to, State law, and a "crowdfunding intermediary" must be used.

S. 1791 represents a considerable improvement from H.R. 2930. Indeed, S. 1791 is in many respects similar to the framework for a model State-level exemption for crowdfunding that is described below.

State Model Rule With Corresponding Federal Exemption

NASAA firmly believes that the States should be the primary regulator of small business capital formation, including crowdfunding offerings. Based on the small size of the offering, the small size of the issuer, and the relatively small investment amounts, it is clear that the States have a more direct interest in these offerings. The States are in a better position to communicate with both the issuer and the investor to ensure that this exemption is an effective means of small business capital formation. The States will be most familiar with the local economic factors that affect small business and have a strong interest in protecting the particular investors in these types of offerings. Further, requiring the SEC to regulate these small, localized securities offerings is not an effective use of the agency's limited resources.

In short, the oversight of these offerings should be done by State regulators.

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[1] According to the Employee Benefits Research Institute's 2009 Retirement Confidence Survey, 53 percent of workers in the U.S. have less than $25,000 in total savings and investments. *http://www.ebri.org/files/FS-03_RCS-09_Saving.FINAL.pdf*

If regulatory authority is preserved for the States, NASAA will pursue the development of a model exemption for crowdfunding that uses many of the components of S. 1791. We have completed an initial draft of a model exemption that includes the following elements:

- An aggregate offering amount to $500,000 over a 12-month period.
- Individual investments are limited to $1,000 per year, per offering.
- It uses a one-stop filing in the State of the issuer's principal place of business. The issuer must provide the home State with contact information and other basic information about the company, and the home State will share the information with other States upon request.
- The issuer has the choice whether to use an intermediary or not.
- To inform investors, the issuer must make basic disclosures on its Web site, including its business plan and proposed use of proceeds. Boilerplate language will be developed to provide investors with important information about the general investment risks of crowdfunding.
- The issuer will be required to escrow investor proceeds until it reaches at least 60 percent of the target investment amount.
- Individuals and companies that have criminal records or have violated securities laws will be precluded from using the exemption.

State securities regulators fully understand the need for small businesses to raise capital and create jobs, and we are willing to accommodate small issuers by creating this very innovative type of exemption. But we also recognize that small business offerings are usually high risk, and there is the potential for significant fraud in this market. To maintain an appropriate balance between investor protection and legitimate capital formation, we believe it is crucial that the States keep their authority over these offerings. The States are the regulator positioned to provide a modicum of investor protection by ensuring that the company exists, that its principals are not bad actors, and that basic disclosures are made to our investors.

II. Removal of the Prohibition on General Solicitation in Regulation D Offerings (H.R. 2940, S. 1831)

On November 3rd, 2011, the House of Representatives voted to pass H.R. 2940, the Access to Capital for Job Creators Act. This legislation, along with identical companion legislation introduced in the Senate by Senator John Thune (S. 1831), would eliminate the ban on "general solicitation" in nonpublic offerings.

Current law requires that securities offerings to the general public be registered with the SEC. Regulation D was built upon the premise that certain offerings should be given special treatment because they are nonpublic, or "private." This means that the investment is marketed only to people with whom the company has a preexisting relationship. Given their knowledge of the company and its operations, these investors are in a better position than the general public to gauge the risks of the investment. They, therefore, have less need for the protections that flow from the securities registration process. This concept of giving preferential treatment to private offerings is embedded throughout State and Federal securities law, and a reversal of this fundamental condition of Rule 506 would have far-reaching repercussions.

The removal of the "general solicitation" prohibition contemplated by H.R. 2940 and S. 1831 would represent a radical change that would dismantle important rules that govern the offering process for securities. However, because many States already allow issuers to use general advertisements to attract accredited investors, NASAA does not oppose outright the underlying goal of H.R. 2940.

H.R. 2940 as modified by the "Garrett Amendment"

NASAA believes it is critical to call the Committee's attention to an amendment to H.R. 2940 that was added to the bill during its consideration by the House Financial Services Subcommittee on Capital Markets. Unfortunately, in the course of its consideration by the House, an amendment sponsored by Representative Scott Garrett resulted, in the introduction of deeply problematic changes to H.R. 2940.

As introduced, H.R. 2940 would have repealed only the ban on general solicitation of accredited investors in offerings made under Rule 506. The Garrett Amendment expanded application of the bill to Section 4(2) of the Securities Act. Thus, in its current form, H.R. 2940 would amend Section 4(2) to provide an exemption for transactions "not involving any public offering, whether or not such transaction involve general solicitation or general advertising." Permitting the public solicitation of investors in an offering that, under law, is deemed a "nonpublic" offering is inconsistent. Therefore, NASAA respectfully suggests that a better approach would be to

adopt an entirely new exemption under Federal law to permit general solicitation of accredited investors.

The MAIE as an alternative to H.R. 2940

One alternative to H.R. 2940 would be to make Federal use of the Model Accredited Investor Exemption (MAIE), which already provides a way under State law for issuers to find accredited investors through a more public offering by allowing an issuer to use a general advertisement to "test the waters" for a proposed offering.[2] There is no limit on the number of investors under the MAIE, and there is no limit on the amount an issuer may raise in an offering under the MAIE. Although only accredited investors may purchase securities offered through the MAIE, dissemination of the general announcement to nonaccredited investors will not disqualify the issuer from claiming the exemption.

A Federal equivalent of the MAIE, with modifications to reflect modern modes of communication, would accomplish the goal of broadening issuers' access to accredited investors. NASAA believes this approach is far better than the approach of H.R. 2940, which undermines the "nonpublic" foundation of Section 4(2) and Regulation D.

If the Committee prefers to move forward with H.R. 2940, however, it should at a minimum remove the Garrett Amendment or section 2(a) of the bill. It is one thing to allow general solicitation of accredited investors within the confines of an offering otherwise conducted in accordance with Rule 506, but it's quite another to allow a general solicitation for all offerings made in reliance on Section 4(2).

III. Increase of the Limit on Regulation A Offerings From $5 Million to $50 Million (H.R. 1070, S. 1544)

On November 2, 2011, the House of Representatives voted to pass H.R. 1070, the Small Company Capital Formation Act. Identical companion legislation (S. 1544) has been sponsored in the Senate by Senator John Tester of Montana.

Under current law, offerings conducted in accordance with Regulation A are subject to the registration requirements of State law. Given the risky nature of these offerings, NASAA believes State oversight is critically important for investor protection. However, we also recognize the cost and difficulty of the typical registration process, and the particular burden it places upon small companies, so we adopted a streamlined process for an issuer to use in an offering under Regulation A. We developed a "Small Company Offering Registration" form that uses a fill-in-the-blank and question-and-answer format to guide a small issuer through the preparation of an adequate disclosure document.

NASAA had significant concerns regarding the original version of H.R. 1070 because it stripped away investor protection by preempting State review of Regulation A offerings that are sold through broker-dealers. However, Representative Schweikert agreed to remove the preemptive provisions of his bill prior to its passage by the House, and the counterpart bill sponsored by Senator Tester in the Senate never included such provisions.

NASAA harbors some concerns regarding the dollar amount of potential offerings under H.R. 1070. Nonetheless, we believe that the States' ability to review these offerings, along with the SEC's proper exercise of discretion in creating reasonable reporting requirements for issuers, will prove to achieve a proper balance of the issuers' needs with investor protection. Accordingly, NASAA does not oppose H.R. 1070 or S. 1544.

IV. Raise the Number of Shareholders of Record for Registration With the SEC (H.R. 2167)

Section 12(g) of the Exchange Act requires issuers to register equity securities with the SEC if those securities are held by 500 or more record holders and the company has total assets of more than $10 million. After a company registers with the SEC under Section 12(g), it must comply with all of the Exchange Act's reporting requirements.[3]

On October 24, 2011, the House Financial Services Committee voted to favorably report the Private Company Flexibility and Growth Act (H.R. 2167), which would raise the threshold for mandatory registration under the Securities Exchange Act of 1934 (the "Exchange Act") from 500 shareholders to 1,000 shareholders for all companies. This bill would also exclude accredited investors and securities held by

[2] The MAIE was adopted by NASAA in 1997 and has been adopted by the majority of States, but its utility is very limited because a corresponding Federal exemption has never been adopted by Congress or the SEC.

[3] The reporting requirements include filing annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy statements on Schedule 14A.

shareholders who received such securities under employee compensation plans from the 1,000 shareholder threshold.

The States are primarily interested in the issues related to the regulation of small, nonpublic companies. We give considerable deference to the SEC in the regulation of public companies and secondary trading. However, we do have concerns about drastic changes in the thresholds for reporting companies or the information they must disclose. Investors and the markets depend upon access to information that public companies are currently required to disclose, and drastic changes could be disruptive and harmful.

The question of an appropriate registration threshold should not just consider the cost to the issuer, but also the cost to investors and the impact on the integrity of the U.S. markets. Giving smaller companies the ability to disclose less information may be counterproductive because it could diminish investor confidence in the markets or drive investors to the larger companies that are required to be more transparent.

The primary reason for requiring a company to be "public" is to facilitate secondary trading of the company's securities by providing easily accessible information to potential purchasers. The principal concern for States is the facilitation of this secondary trading market with adequate and accurate information. It may be possible to achieve this without full-blown Exchange Act registration and periodic reporting, but the States are wary of changes that may lead to the creation of less informed markets. Because the Exchange Act registration and periodic reporting requirements are designed to protect and inform purchasers in the secondary trading market, a company's obligation to become an Exchange Act filer should be based upon the need for liquidity in such a market. Determining this need requires an assessment of the potential activity in the secondary trading market. This activity is best measured by the count of beneficial holders, not record holders, and would include all accredited investors, employees, and crowdfunding investors, because they will be active in the secondary trading market.

No matter what threshold number is chosen before a company becomes "public," it makes little sense to exclude any investor from the count of beneficial holders. Those that purchased from the issuer were protected by the requirements of the Securities Act. The Exchange Act, and Section 12(g), serves a different purpose—providing a trustworthy, truthful marketplace so that shareholders have liquidity and that secondary buyers have adequate information upon which to make their purchase decision. Accordingly, it makes no difference that the seller in this market is an accredited investor or an employee. Both the seller and the purchaser benefit from the robust marketplace facilitated by the Exchange Act registration.

In short, the registration threshold should be based upon the need to provide for a legitimate secondary trading market. Regardless of where the threshold is set, everyone who is a potential seller in the market should be counted. This would include all beneficial owners, not just holders of record.

V. Raising the Threshold of Record Holders That Triggers Registration for Banks and Bank Holding Companies (H.R. 1965, S. 556)

On November 2, 2011, the House of Representatives voted to pass H.R. 1965, which would amend Section 12(g) of the Exchange Act by raising the threshold that triggers registration from 500 to 2,000 record holders for banks or bank holding companies. The bill would also modify the threshold for deregistration under Sections 12(g) and 15(d) of the Exchange Act for a bank or a bank holding company from 300 to 1,200 shareholders. The bill is a companion to a Senate bill (S. 556) by Senator Kay Bailey Hutchison (R-TX) and Senator Mark Pryor (D-AR).

NASAA understands H.R. 1965 to be a bill designed to remedy a unique and specific problem that is today confronting certain community banks.

Specifically, as a result of the increasing costs of public company registration, many community banks have determined that deregistration is in the best interests of their shareholders. But in order to deregister, community banks must have fewer than 300 shareholders. As a result, community banks must often buy back shares to deregister, which reduces the access of small banks to capital and deprives small communities of an opportunity to invest in local companies.

Given the narrow scope of the bill and its application only to banks and bank holding companies, NASAA has not taken any position on H.R. 1965 or its Senate companion.

Conclusion

As regulators, States are guided by the principle that every investor deserves protection and an even break and has the right to not be cheated or lied to. As we saw with the passage of NSMIA in 1996, State securities regulators have been hand-

cuffed from reviewing certain offerings before they were sold to members of the public. Since then, a regulatory black hole has emerged to expose investors to high-risk investments offered by companies with little or no financial stability or regulatory scrutiny.

In the 15 years since the National Securities Markets Improvement Act of 1996 became law, it has become painfully clear that preemption of State review of offerings is a failed experiment. We must not let history repeat itself by creating more regulatory black holes and exposing investors to unacceptable levels of risk and outright fraud.

State regulators understand the complex challenges faced by small business issuers. We also understand that a reasonable balance of the issuers' interests and the investors' interests is in the best interest of both groups. It protects the investors, and it facilitates the market for the issuers' securities. If the investors do not trust the small business issuer market, they will not invest.

The States are ready to play an active role in balancing these two interests. We believe that reasonable registration or exemption provisions can be adopted that benefit only those issuers for which they are designed, disqualify "bad boys," and provide for reasonable investor qualifications and protections. Further, we remain adamant that these provisions must preserve the ability of States to protect the interests of investors.

Thank you again, Mr. Chairman, for the opportunity to testify before the Committee today. I will be pleased to answer any questions you may have.

PREPARED STATEMENT OF JOHN C. COFFEE, JR.

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DECEMBER 1, 2011

Chairman Johnson, Ranking Member Shelby, and fellow Members of the Committee, I am happy to be here today and appreciate the balanced approach that the title for these hearings reflects. We want at the same time to spur job growth and minimize any sacrifice of investor protection. I support the intent of the bills now pending before the Senate to facilitate smaller offerings at low cost (particularly S. 1544 and S. 1831). Still, without some changes (which are essentially modest), one of these bills (S. 1791) could well be titled "The Boiler Room Legalization Act of 2011." Of even greater concern to me is the overbreadth inherent in S. 1824, which pushes up the threshold at which an issuer must become a "reporting company" and make periodic disclosures to the market to 2,000 shareholders of record. I can understand the case for increasing the threshold under Section 12(g), but the problem with the approach taken is that record ownership is easily manipulated and companies could come to have 5,000 or more beneficial shareholders (and billions in stock market capitalization) without becoming subject to the increased transparency of the Securities and Exchange Act of 1934. There is no need for such an open-ended exemption (largely benefiting larger firms) or for such a dramatic retreat from the principle of transparency that has long governed our securities markets in order to spur job creation at smaller firms.

I. Introduction

In a nutshell, let me define the contours of the dilemma. There is considerable reason to believe that smaller businesses disproportionately create jobs. But smaller businesses have been increasingly shut out from access to the public equity markets. Although smaller IPOs (usually defined as IPOs of under $50 million) once accounted for as much as 80 percent of all IPOs, that pattern changed abruptly in the late 1990s. Since then, smaller IPOs (again defined as those seeking to raise less than $50 million) have constituted less than 20 percent of the number of all IPOs.[1] This pattern is unlikely to change. Much as some wish we could turn the clock back to the mid-1990s, the smaller IPO has largely disappeared for a variety of reasons, including:

1. There are high fixed costs to an IPO. The greater the size of an offering, the less these fixed costs—for lawyers, accountants, offering expenses, *etc.*—represent as a percentage of the total offering. Hence, small IPOs are an economically inefficient way to raise capital;

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[1] *See,* Statement of David Weild before the House Financial Services Committee, Subcommittee on Capital Markets and Government Sponsored Enterprises, on March 18, 2011. *See, also,* Grant Thornton, "Stock Markets, Capital Formation and Job Creation Under Attack" (2011).

2. Institutional investors are the primary buyers of IPOs, but institutional investors want secondary market liquidity, and they can rarely obtain such liquidity unless the market capitalization of the IPO issuer is equal to $500 million or more;
3. The market infrastructure that supported smaller IPOs, including multiple securities analysts following and supporting the stock, is largely gone, and smaller IPOs may not be followed by any analyst; and
4. The retail public still remembers the Internet bubble of 2000 and the Enron/WorldCom scandals of 2001–2002. Once investor confidence is lost (because of conflicted analysts, offering hyperbole, and dubious financial statements), it is not easily recovered.

A final reason why smaller IPOs have declined is that smaller issuers have found it easier, quicker, and less costly to raise capital in the private markets than in the public markets. Smaller issuers prefer to avoid the higher liability and greater SEC oversight that is associated with public offerings. Accelerating this shift from public to private markets was the gradual relaxation of SEC Rule 144's holding period for "restricted securities" issued in private placements. In early 1997, the SEC amended Rule 144 so that the purchaser of "restricted securities" could resell them into the public market after an only one year holding period (as opposed to the prior two year holding period rule), and almost immediately thereafter smaller public offerings fell off dramatically, crashing from over 75 percent of the number of all IPOs in 1996 to less than 20 percent in 1998.

This shift toward the private market has continued and accelerated. In 2010, SEC Commissioner Elisse Walter estimated last month that over $900 billion in securities were sold pursuant to Regulation D (which is the primary SEC rule exempting private placements from registration under the Securities Act of 1933). Similarly, the SEC's Chief Economist has recently estimated that, since the beginning of 2009, there have been some 37,000 Regulation D offerings reported to the SEC[2] (and in all likelihood this underestimates the use of Regulation D because many such offerings are not reported to the SEC). The median size of these offerings was approximately $1 million. Thus, the implication seems clear: smaller issuers have displayed a marked preference for private offerings, and this preference is likely to persist.

II. The Pending Bills

This introduction sets the stage for my comments on the bills before this Committee. Basically, I believe that S. 1544 and S. 1831 are useful efforts to facilitate exempt offerings. Although I have some skepticism about whether they will significantly increase or expedite the raising of capital, they do not sacrifice investor protection. In contrast, S. 1791 is an innovative effort to facilitate the raising of small amounts of capital from retail investors. Although we all want to be Internet-friendly, S. 1791, in its present form, seems likely to invite a significant amount of fraud that could, over the longer run, stigmatize those attempting to market smaller offerings. Still, with some adjustments that would not raise the costs of such an offering procedure, I believe that the potential for fraud and "boiler room" marketing could be substantially curtailed. Finally, S. 1824 seeks to delay the point at which smaller companies must become "reporting" companies under the Securities Exchange Act. This is understandable, but the approach it takes is overbroad and it could permit some very large companies (i) to avoid the transparency and periodic disclosure mandated by the Securities Exchange Act, or (ii) to "go dark" (that is, cease to become reporting companies), even though they had already become reporting companies and had a significant market capitalizations, shareholder populations, and trading volumes. This is unnecessary, but again a small revision could reduce this potential, while still enabling smaller companies to avoid these costs.

A. S. 1544 (The Small Company Capital Formation Act of 2011). This legislation raises the ceiling on the exemption for small issues under Section 3(b) of the Securities Act of 1933 from $5 billion to $50 million. This provision strikes me as balanced and well-crafted because at the same time as it raises the ceiling under Section 3(b), it adds additional investor protections, including (1) a clearly specified litigation remedy (Section 12(a)(2)); and (2) audited financial statements. As before, an offering statement would be filed with the Commission, and periodic disclosure would be required to the extent that the Commission directs.

In sum, investors receive (1) SEC oversight; (2) a detailed disclosure document; (3) continuing periodic disclosure; and (4) a negligence-based litigation remedy that

[2] *See,* Craig Lewis, "Unregistered Offerings and the Regulation D Exemption" (2011) (Powerpoint slides).

roughly approximates the remedy that they would receive in a registered public offering.

Two aspects of S. 1544 do give me some concern. First, Section 2(b) of S. 1544 would deem securities sold in certain offerings under Section 3(b) to be "covered securities" and hence exempt from registration with State "Blue Sky" commissioners (at least if the securities are sold to a "qualified purchaser" as defined by the SEC). It is unclear how the Commission will use this authority (and the Commission could preclude offerings to unsophisticated investors as the price of escaping Blue Sky regulation). Although I recognize that smaller offerings tend to fly under the SEC's radar screen and to be principally monitored by the Blue Sky commissioners, S. 1544 does permit these Blue Sky commissioners to retain their antifraud authority under Section 18(c) of the Securities Act. Thus, it is only their authority to require registration of the offering that is preempted. This presents a close question.

In evaluating whether it is desirable to preempt State registration of offerings under Section 3(b), this Committee may want to consider the very limited incentive that today exists to use this Section 3(b) exemption. I have been advised by SEC staffers that in 2010 only seven offerings went effective under Regulation A (which is based on Section 3(b)). Most issuers saw Section 3(b) as unattractive (in comparison to a private placement under Regulation D) both because of Section 3(b)'s low ceiling (*i.e.,* $5 million) and the need to file an offering document that is reviewed by the SEC. Raising the ceiling to $50 million does not necessarily imply that this provision, as revised, will be more attractive than Rule 506 under Regulation D (which has no ceiling on the amount that may be offered and does not require SEC approval of the offering document). I suspect that Regulation D will remain far more popular than Regulation A, even with the revised ceiling on Regulation A. In this light, preempting State registration of Regulation A offerings may represent an additional, but small, step towards increasing the attractiveness of a Regulation A offering. Unlike Regulation D, Regulation A offerings may today be marketed to retail investors (and without any limit on their number), and a general solicitation of investors is possible. Thus, its use could increase, but frankly I am skeptical that there will be any dramatic rise in its use.

A second concern relates to the authority given the SEC by Section 2(a)(5) of S. 1544, which authorizes the Commission to increase the ceiling on the Section 3(b) exemption and instructs the Commission to review this matter every two years. This authority is open-ended, and conceivably a future Commission could increase the Section 3(b) ceiling from $50 million to $500 million. I suggest it would be advisable to limit this authority to some form of inflation indexing.

B. S. 1831 (the "Access to Capital for Job Creators Act"). I believe this to be the least controversial of the bills now pending before this Committee. Its intent is to simplify the private placement process and allow issuers to contact a broader range of investors by eliminating the existing ban on general solicitation (at least in cases when only accredited investors are solicited). *See,* SEC Rule 502(c) (prohibiting a general solicitation or general advertising under Rules 505 and 506 of Regulation D). This idea is hardly radical, as the SEC in past years has discussed the possibility of deleting the general solicitation prohibition. The rationale for this change would be the same that governs in the NBA: "No Harm, No Foul." Accredited investors are deemed to be sophisticated, and thus a general solicitation of them harms no one—in theory.

Of course, this theory may be overbroad in that many accredited investors are unsophisticated and even naive. The standard for an accredited investor is only $1 million in net worth or a $200,000 income for the most recent 2 years (*see,* SEC Rule 501(a)(5) and (6)). Thus, much of the American middle class is reached by this term. Nonetheless, this proposed revision will simplify private placements and allow smaller issuers to reach more investors at low cost. In that sense, its benefits may exceed its costs.

But there is a serious problem with the drafting of S. 1831, at least if the intent is simply to allow a general solicitation of accredited investors. Section 2(a) of S. 1831 would revise Section 4(a) of the Securities Act of 1933 to read as follows:

> (a) transactions by an issuer not involving any public offering, whether or not such transactions involve general solicitation or general advertising.

Section 2(b) then instructs the SEC to revise its rules to permit a general solicitation in connection with a Rule 506 "provided that all purchasers of the securities are accredited investors."

The problem here is that Section 2(a) covers with a blanket what Section 2(b) wants the SEC to cover only with a napkin. The plain meaning of the language of Section 4(2), as revised by Section 2(a) of S. 1831, is to permit a general solicitation in all private placements, including those not restricted to accredited investors. Both

the Supreme Court and the D.C. Circuit Court of Appeals have shown, time and time again, that they will focus on the plain meaning of the statutory language and ignore legislative history.

Thus, I would suggest that, if Section 4(2) is to be revised at all (and a statutory revision of it is not really necessary, given Section 2(b)), it should be amended to read:

> (a) transactions by an issuer not involving any public offering, including transactions involving a general solicitation or general advertising to the extent such solicitation or advertising is permitted by rules or regulations adopted by the Commission.

The Commission could still be instructed by Section 2(b) as to how to exercise its discretion in this regard. Alternatively, no change need be made at all in Section 4(2) of the Securities Act, as Section 2(b) alone should be sufficient.

C. S. 1791 (Democratizing Access to Capital Act of 2011). This bill has an innovative premise: namely, to allow issuers to solicit retail investors through the Internet without providing any meaningful disclosure document and without prior SEC oversight, so long as the amount that may be sold to each investor is small. Under S. 1791, no individual investor could invest more than $1,000 in such an offering.[3] Presumably, such offerings would remain subject to Rule 10b-5 (because no anti-fraud exemption is provided).

Because the maximum aggregate amount that may be raised in any 12-month period is $1 million, this exemption is likely to be used primarily by early stage issuers that do not yet have an operating history or, possibly, even financial statements. Such issuers are in effect flying on a "wing and a prayer," selling hope more than substance. Precisely because of this profile, however, such offerings are uniquely subject to fraud, and some issuers will simply be phantom companies without any assets, business model, or real world existence.

To enable these early stage issuers to seek small investors, S. 1791 confers both an exemption from offering registration under Section 5 of the Securities Act and an exemption from broker registration under the Securities Exchange Act. Of these two exemptions, the latter should be of greater concern, because it offers unparalleled opportunities for the traditional boiler room operation to reemerge.

To understand this point, let's focus on how fraudsters could most easily exploit this exemption from broker-dealer registration. Unlicensed salesmen (some of whom might have been banned for life from the securities industry) could set up shop and solicit potential investors by phone, email, or face-to-face contacts. They could create very short profiles of phantom companies, display them on a Web site, invite customers to view them, and then seek "hard sell" follow-up meetings. Even though a single customer could not invest more than $1,000 in any single company, such a customer could be induced by salesmen to invest in five or six different companies. The salesmen's motivation could be either to pocket the entire proceeds received from the investors (telling them, if later questioned, that the business failed) or to deduct an inflated sales commission from the investor's payment for shares.

How is the prospect for such fraud best limited without also precluding a "crowdfunding" solicitation? I suggest the best strategy is two pronged: (1) keep the Web site (or "crowdfunding intermediary" in S. 1871's terminology) largely passive; that is, do not permit to engage in any active solicitation beyond display of the issuer's offering materials on its Web site; and (2) require those who engage in active solicitation of investors (by any means other than a passive Web site) to register as broker-dealers. Thus, the "broker and dealer exemption" in Section 7 of S. 1791 should be limited so that it applies to a Web site that does not itself allow its employees to solicit sales or that does not pay outside agents to do so. The issuer could, of course, pay agents to solicit, but they would have to be registered brokers. This approach allows a "crowdfunding intermediary" to serve as a conduit for the issuer's offering materials without registration as a broker, but it confines this unregistered intermediary to a passive role. Active selling would be limited to registered brokers (who are subject to the oversight of FINRA and SEC rules regarding brokers).

Failure to adopt this approach (or some similar variant) would likely mean that every barroom in America could become a securities market, as some unregistered salesman, vaguely resembling Danny DeVito, could set up shop to market securities under the "crowdfunding exemption." Under the current version of S. 1791, such a person could open his laptop on the bar, show slides of a half dozen companies to the bar's patrons, and solicit sales. This will create few jobs (except for dubious unregistered salesmen) and much fraud.

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[3] The House bill, however, provides a $10,000 ceiling on individual investor purchases.

If this Committee decided that it wanted to restrict active securities solicitations by a "crowdfunding intermediary," the simplest way to do so would be to expand the proposed language in Section 7 of S. 1791, which language would amend Section 3(a)(4) of the Securities Exchange Act of 1934. Proposed Section 3(a)(4)(G)(ii)VII could be revised to read:

> (VII) does not (a) offer investment advice or recommendations, (b) solicit purchases, sales, or offers to buy the securities offered or displayed on its Web site or portal, or (c) compensate employees, agents, or other third parties for such solicitation or based on the sale of securities displayed or referenced on its Web site or portal.

This language is intended to permit an exempt intermediary to display the issuer's offering materials but not otherwise to solicit sales, leaving that task for registered brokers.

One last comment about the proposed "crowdfunding exemption": the existing language in S. 1791 does not address the SEC's integration doctrine. An issuer who utilizes proposed Section 4(6) to make a $1 million offering might cause the issuer to sacrifice its ability to make an exempt offering under some other exemption for a period beginning 6 months before the start of, and extending until 6 months after the end of, the crowdfunding offering. See SEC Rule 502(a) (defining the general contours of the integration doctrine and employing a 6 month safe harbor before and after the offering). See also Securities Act Release No. 33-4552 (November 6, 1962). To prevent this, a section might be added to S. 1791 instructing the Commission to adopt rules to ensure that use of the "crowdfunding exemption" in Section 4(6) will not cause the issuer to forfeit other exemptions.

D. S. 1824 (the "Private Company Flexibility and Growth Act"). This bill is intended to delay the point at which a company must become a "reporting" company under Section 12(g) of the Securities Exchange Act (and thus required to make periodic disclosures to the market on at least a quarterly basis). Specifically, it would raise the limit from 500 shareholders of record (on the last day of the issuer's fiscal year) to 2,000 such record holders (as of the same moment). The offered rationale for this change is, at least in part, that many private companies have been delayed in their ability to consummate an IPO, and this delay has forced their employees holding stock options to either exercise (and become shareholders of record) or let the options expire. As a result, some private companies (most notably Facebook) are approaching the 500 shareholder limit before their likely IPO date.

There are several obvious solutions to this problem. First, one could simply exempt securities held by employees from this computation, and Section 3 of S. 1824 does this. Second, shareholders in these companies could hold shares beneficially (and not of record) by using a broker or bank as an intermediary. Such "street name" ownership is today the prevalent mode of ownership in public companies.

The problem with expanding the threshold for reporting status under Section 12(g) of the Securities Exchange Act is that record ownership is outdated—in effect, a relic of a bygone era. Using a 2,000 shareholder of record ceiling would enable some companies to remain "dark" (*i.e.,* not to enter the SEC's continuous disclosure system), even if they had total assets in the billions of dollars and possibly 10,000 beneficial shareholders. In short, companies could exploit this provision by insisting that shareholders hold their stock only in "street name" (or by repurchasing the shares of those unwilling to do so).

In addition, proposed Section 5 of S. 1824 would permit a bank or bank holding company that was already a "reporting" company to deregister under Section 12(g)(4) of the Securities Exchange Act (and thus "go dark" in the parlance) if it could cause the number of its shareholders to fall below 1,200 shareholders of record. Again, this could be manipulated by inducing shareholders to hold in street name.

The Federal securities laws have insisted upon transparency on the part of a company with a substantial number of shareholders since 1964. In 1964, "shareholders of record" was a meaningful concept; today it no longer is. The proposed language is a threat to that principle of transparency. Put simply, "going dark" invites bad things: undisclosed self-dealing, conflicts of interest, etc. Some companies might also wish to go dark to avoid the Foreign Corrupt Practices Act (some of whose provisions apply only to reporting companies).

I do not suggest that the 500 shareholder threshold is immutable and cannot be revised. The real problem is that the "shareholder of record" concept is archaic and can be gamed. A superior test would look to the size of the company's "public float" (*i.e.,* the value of the securities held by nonaffiliates) in order to determine whether the company should enter the SEC's continuous disclosure system. This public float test has been used by the SEC in determining eligibility for Form S-3 and is easily

calculated. Although it is impractical to compute the number of a company's beneficial holders, it is very simple to compute its "public float." Under such a test, it would make no difference whether shares were held beneficially or of record. But the value of stock held by affiliates and controlling persons would not be counted, thus permitting family controlled companies to remain private.

Of course, a compromise is possible here: a shareholder of record test could be used, subject to a proviso that a company with a specified market capitalization held by nonaffiliated shareholders would still have to become a reporting company. Thus, the relevant lines in Section 12(g)(1) of the Securities Exchange Act might require an issuer to register under it when:

> the issuer has total assets exceeding $10,000,000 and a class of equity securities (other than an exempted security) held of record by 2,000 persons; provided however, that, without regard to the number of its shareholders of record, an issuer with a class of equity having a market value on the last day of its fiscal year (excluding for this purpose the value of such shares held by affiliates of the company) in excess of $[500 million] shall be required to register under this section within 120 days after the end of such fiscal year.

This approach simply says that at some point a company which has successfully kept its shares in beneficial ownership through the use of brokers or other intermediaries will still have to register and become a "reporting" company. My use of a $500 million threshold is simply for purposes of illustration (as, I believe, few could quarrel with a threshold that high).

PREPARED STATEMENT OF CHRISTOPHER T. GHEYSENS

EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL AND ADMINISTRATIVE OFFICER, WAWA, INC.

DECEMBER 1, 2011

I. Introduction

Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, thank you for holding this hearing on what I believe are two of the most pressing issues our Nation faces, job creation and capital formation. My name is Christopher (Chris) T. Gheysens. I am currently Executive Vice President and Chief Financial and Administrative Officer, for Wawa, Inc. (Wawa). I have been selected to become Wawa's next President and Chief Executive Officer effective in the next year. I am here today to testify on behalf of Wawa.

As Chief Financial and Administrative Officer for Wawa, my primary responsibilities include leading all aspects of the Financial, Legal and Human Resource functions. I became CFO in January 2006 and have worked at Wawa for over 14 years, previously holding positions of Director of Planning & Analysis and Retail Accounting Manager.

Prior to joining Wawa, I worked in the audit practice at Deloitte LLP in Philadelphia. During my 4 years with Deloitte, I focused primarily on the retail industry, serving clients such as Reading China and Glass, The Wall Music, The Pep Boys, and Wawa.

I graduated from Villanova University with a Bachelor of Science degree in Accountancy in 1993. I obtained a Master's of Business Administration from Saint Joseph's University and am a Certified Public Accountant in New Jersey.

I have been an active member of the Board of Directors and Finance Committee for the Southeastern Pennsylvania Chapter of the American Red Cross since June 2009.

While I understand the Committee will examine several bills related to job creation and capital formation, and I support the purpose behind these bills, I am here to speak specifically to Wawa's support for S. 1824, the Private Company Flexibility and Growth Act, introduced by Senators Toomey and Carper. This legislation is cosponsored by Senators Warner, Kirk, and Johanns, who are also Members of this Committee, as well as Senator Scott Brown.

I would like to thank Senator Toomey and all of the Members of the Committee who have cosponsored S. 1824. Wawa is encouraged by the strong bipartisan support of this legislation that will benefit all Americans in this time when job creation and economic stimulus are most critical.

II. Wawa Information and History

Wawa is headquartered in Senator Toomey's home State of Pennsylvania, in an area that is 20 miles southwest of Philadelphia. Wawa is a privately held company that was founded over 200 years ago by the Wood family as an iron foundry in New Jersey. Toward the end of the 19th century, owner George Wood took an interest in dairy farming and the family began operating a small dairy in Wawa, Pennsylvania. As home delivery of milk declined, Grahame Wood, George's grandson, opened the first Wawa Food Market in 1964 as an outlet for our dairy products, the same year that the 500 shareholder limit was put in place. This year marked our 47th year in the retail business. Throughout our history, we have maintained several deeply held beliefs, not the least of which are to remain a privately held company and to promote shared ownership with our associates. Private ownership allows us to take a long-term point of view and make long-term investments to ensure our business is sustainable. The founding family has always believed in sharing ownership with our associates. The belief in shared ownership is a part of Wawa's DNA and fosters an ownership mentality in our associates, creating a significant competitive advantage by having "owners," not employees.

We are considered one of the most successful privately held companies in America, having evolved into a regional convenience store chain with over 590 stores in Pennsylvania, New Jersey, Virginia, Delaware, and Maryland, three of which are the home States of Members of this esteemed Committee, Senators Toomey, Menendez, and Warner. Wawa employs approximately 18,000 associates. Wawa also recently broke ground for our first store in Florida, with plans to construct as many as 100 stores in Florida over the next 5 years, expending over $500 million in Florida alone and creating approximately 3,000 new jobs at Wawa in the local economy.

Through the years, Wawa has consistently invested in the communities in which we operate. Our stores represent long-term investments, and our growth has fueled the success of other businesses and organizations in the community. Wawa's connection with the community goes well beyond that of a typical business. Being a good neighbor and recognizing our responsibility to the communities in which we live and work is an equally important part of our business. Every year, we commit millions of dollars in contributions in financial grants from the Wawa Charities Fund, we conduct in-store fundraising campaigns that have a significant, positive impact on regional and local charities and we support numerous special events through product donations and volunteering.

III. The Private Company Flexibility and Growth Act

I would like to commend this Committee for its consideration of the Private Company Flexibility and Growth Act. This legislation would amend the Securities Exchange Act of 1934 (the "Act") to increase a shareholder registration threshold that has not been updated since 1964. While the United States has undergone vast changes since 1964, including Wawa's dramatic expansion from one store to nearly 600, this shareholder threshold has stayed the same. This proposed legislation will provide companies the flexibility to remain privately held, while continuing to grow and remain strong drivers of economic development and prosperity.

Section 12(g) of the Act requires a company to register its securities with the U.S. Securities and Exchange Commission (the "SEC") if it has more than 500 shareholders of record and assets exceeding $10 million. As Wawa has grown and its shareholder base has increased, we recognize that the 500 shareholder limit will cause our organization to face a significant issue in the not-so-distant future, in that we will be required to choose between becoming a public reporting company and initiating a costly, time consuming corporate restructuring. Our culture of shared and private ownership would guide us to choose the costly restructuring at the expense of future growth.

The Toomey/Carper Private Company Flexibility and Growth Act would raise the existing 500 shareholder threshold to 2,000 shareholders before a company would be required to register under the Act. The bill would also exempt shares awarded to employees pursuant to compensation plans from this registration threshold. Wawa believes this legislation is worthy of your support because it would provide additional flexibilities to a variety of companies, some like Wawa that are well established, and others that are not. I am confident that the additional flexibility offered to privately held companies under the proposed legislation will allow such companies to use scarce resources on research and development, new store growth and job creation, rather than on regulatory compliance costs. In summation, by updating this almost five-decade old threshold, Congress will take needed steps to foster continued growth for private companies, like Wawa, allowing them to continue to add jobs, build new stores and be strong economic drivers.

Wawa, like many other privately held companies, has made the strategic decision to remain private for competitive and cultural reasons. Based on Wawa's 200-plus years of experience, the company has seen that privately held companies can focus on long-term results, rather than being concerned solely with short-term results in order to meet Wall Street analysts and other third-party expectations. This long-term focus by privately held companies, in turn, can create prosperity throughout the economy through growth, innovation, and investment, and has a multiplier effect on suppliers, builders, contractors, and vendors that support their businesses.

In the case of Wawa, we believe that we are creating value for our customers, more sustainable growth for our company and a more stable working environment for our associates. Specifically, it is our belief that privately held companies are able to create more generous benefit packages for their employees, since they do not have to be as concerned with short-term earnings. In fact, during the most recent recession and extended period of weak corporate and overall economic growth, Wawa has been able to maintain generous compensation and benefits, while avoiding layoffs because of our long-term view.

In addition, privately held companies are more likely to have Employee Stock Ownership Plans (ESOPs), which enable employees to share in the growth of the company by having a personal financial stake in the business. This, in turn, creates a more engaged employee since they benefit directly from the company's success. Wawa also provides senior level management equity through stock-based compensation plans. These plans allow Wawa to attract and retain talented associates that help drive growth and, ultimately, create jobs. Our ability to utilize this form of compensation becomes limited as we approach the 500 shareholder limit. One manner in which to address the 500 shareholder limit is the implementation of a reverse stock split. Such a mechanism would take as much as $40 million of capital away from new store growth and likely eliminate as shareholders many of the associates these plans are designed to attract and retain.

Public reporting companies in the U.S. are required to meet financial reporting requirements associated with SEC reporting. A 2007 law firm study of public company compliance costs indicates that the average annual cost of compliance for companies with under $1 billion in annual revenue could approach $2.0 million or more. A privately held company has no such requirements, enabling it to invest the funds it would otherwise pay in the form of very expensive professional fees into capital assets and job creating activities. We recognize that raising the shareholder limit could add to the pool of the investing public who would not, by regulation, have access to certain basic financial disclosure.

We value and understand the need to provide shareholders current financial information. This is consistent with our culture of sharing ownership and treating our associates as owners. At Wawa, we provide our shareholders and associates access to quarterly financial updates and detailed annual financial reports that keep them informed of our company's progress and health.

IV. Conclusion

We have always believed that being privately held is better for our associates, our shareholders, and our company's long-term growth. Our culture of teamwork and our family atmosphere is a direct reflection of our private ownership and heritage. The short-term pressures and interference of a third party are not consistent with our values or the culture that has enabled us to flourish for more than 200 years. Without an increase in the shareholder limitation, Wawa would need to take a significant amount of capital away from activities that will drive job creation and economic growth for our communities.

We hope to have the flexibility needed to be able to continue to grow, add jobs and be an economic driver in our communities for another 200 years.

Thank you again for the opportunity to testify today. I look forward to answering any questions that the Committee Members may have.

PREPARED STATEMENT OF SCOTT CUTLER

EXECUTIVE VICE PRESIDENT AND CO-HEAD, U.S. LISTINGS AND CASH EXECUTION, NYSE EURONEXT

DECEMBER 1, 2011

Chairman Johnson, Ranking Member Shelby, Members of the Committee: My name is Scott Cutler, Executive Vice President of NYSE Euronext—the world's leading and most diverse exchange group with equities, futures and options markets throughout the United States and Europe. I appreciate the opportunity to testify

today regarding ways to stimulate job growth and innovation through capital formation while protecting investors.

Young, innovative, emerging growth companies are the engines of job creation, and access to capital through initial public offerings is key to allowing these innovative companies to grow and hire new employees. From 1980 to 2005, firms less than 5 years old accounted for all net job growth in the U.S. For those companies that "go public," 92 percent of job growth occurs after the company's IPO, and most of that within the first 5 years after the IPO.[1] Clearly, an IPO provides these young and growing companies an opportunity to expand their business and hire more workers.

Our public markets provide significant benefits for issuers, investors and our economy. Public companies obtain permanent access to capital, the ability to reach the deepest pool of both institutional and retail investors, and the power to use their stock as currency for future acquisitions. Founders, employees, and public shareholders obtain liquidity for their investments and the opportunity to transact in real-time, in a transparent and well-regulated market that provides extensive issuer disclosures while protecting both buyers and sellers. It is this symbiotic relationship between issuers and investors that make our markets function so well.

However, over the past decade, the number of young companies going public has declined significantly, and the age of companies at the point of their IPO has increased. While in 1996, there were 761 companies that underwent an IPO, an average of fewer than 157 companies went public per year between 2001 and 2008, and the number remains well below historical norms. At the same time, the average age of a company at the time of its IPO has increased from 5½ years during the period from 1997 to 2001, to 9 years from 2006 to 2011.[2]

Rather than pursue an IPO, early investors have shifted toward gaining liquidity for their investment by selling their young companies to larger enterprises. While in 1991, about 90 percent of venture investor exits occurred through an IPO and about 10 percent through a merger and acquisition (M&A) event, this trend has completely reversed in recent years: in 2010, about 80 percent of exits were through M&A compared to 20 percent through an IPO.[3] This shift is critically important because an M&A event does not generally produce the same job rapid growth as an IPO, and often results in job losses over the short term as the acquirer eliminates redundant positions.

The movement away from IPOs has been driven in large part by burdensome regulatory hurdles. In particular, extensive regulatory reporting requirements in order to go public and remain a public company have increased the cost of going public. This is a significant barrier that every CEO we meet highlights as an obstacle to pursuing an IPO.

At the same time, regulatory requirements have also limited the amount of research about these emerging companies available to investors, constraining investor interest. We believe that additional research enhances investors' understanding of emerging companies and facilitates the demand side of the equation.

Removing these barriers to going public is critical to unlocking emerging growth companies' job creation potential.

Several members of this Committee have taken the lead on a bill, the Reopening American Capital Markets to Emerging Growth Companies Act of 2011, which would significantly reduce the obstacles that prevent emerging growth companies from going public—and accessing the capital to hire more employees—while maintaining important investor protections. The bill would tackle both sides of the equation: addressing companies' reduced interest in an IPO due to the costs of going public, while facilitating the sharing of information with investors to stimulate awareness and demand.

The bill would create a transitional category of companies pursuing an IPO called "emerging growth companies." This category would generally include those companies pursuing an IPO that have less than $1 billion in annual revenue and less than $700 million in public float (common equity held by nonaffiliates) and would not affect any company that has already completed its IPO. For this small number of emerging growth companies, certain disclosure and other public company regulatory requirements would be reduced or phased-in, thus lowering the costs associated with an IPO and complying with public company requirements. The maximum

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[1] Venture Impact Study 2010 by IHS Global Insight. *http://www.nvca.org/index.php?option=com_content&view=article&id=255&Itemid=103.*

[2] Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth, p. 6. *http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=805&Itemid=93.*

[3] *Ibid* at 7.

phase-in period would be 5 years from the IPO date (with the phase-in being eliminated earlier if a company reached the $1 billion in revenue or $700 million in public float levels). In particular:

- Emerging growth companies would have scaled-back financial information requirements and scaled-back requirements in their "Management's Discussion and Analysis" and "Executive Compensation" disclosures. Many of these scaled-back requirements are already permitted for microcap companies with less than $75 million of public float.
- One of the largest expenses associated with becoming a public company is the cost of complying with the requirement to obtain an auditor attestation of a company's internal controls over financial reporting, under Section 404(b) of the Sarbanes-Oxley Act. The bill would phase-in this requirement, giving emerging growth companies the chance to go public, expand and hire before incurring this expense.

At the same time, emerging growth companies would be able to "test the waters" to gauge investor interest and provide more research information to prospective investors:

- Many emerging growth companies may consider an IPO, but are unsure of whether there is sufficient investor interest. Because current law makes it difficult for companies to test the waters and gauge interest before actually undergoing the expense of preparing an IPO registration statement, companies may forgo an IPO altogether. The bill would allow these pre-IPO companies to communicate with sophisticated investors about a potential IPO, and consider the probability of an IPO's success, before undergoing the expense of preparing a registration statement.
- On the other side of the equation, restrictions on investment banks providing research coverage on emerging growth companies undergoing an IPO have limited investors' ability to obtain information—and thus their ability to assess whether to invest in an emerging growth company. The bill would improve the availability and flow of research coverage by scaling back regulatory restrictions that prevent such coverage.

By phasing-in some of the more expensive regulatory requirements of being a public company, and scaling back restrictions on research coverage, the bill will allow more emerging growth companies to access the public capital markets, finance their growth and create more American jobs. Our system of securities regulation, including the robust disclosures required of large or seasoned public companies, would be maintained—while the largest obstacles preventing our most promising young companies from growing and hiring would be removed.

While this bill would remove roadblocks from accessing the public markets for emerging growth companies, the extensive process of SEC registration may still be overly burdensome and expensive for some smaller companies and start-ups, who need a method of raising smaller amounts of capital through a less restrictive and less expensive process. I would therefore also like to comment on a number of other legislative proposals.

I applaud the House for passing H.R. 1070, the Small Company Capital Formation Act of 2011, and commend Senators Tester and Toomey for their leadership on this issue in the Senate. I encourage the Committee to pass S. 1544 as well. This bill would expand the size of offerings eligible to use the scaled-back process for publicly offering securities under Regulation A for small public offerings, from $5 million to $50 million. This would help small companies access public capital and grow their businesses without the more extensive undertaking and expense of full registration under the Securities Act. At the same time, investors are protected as Regulation A securities are traded in the light of the public markets and investors are provided with significant disclosure regarding each issuer.

In contrast to the well-regulated and transparent public markets, private markets provide investors with much less protection, with reduced or no disclosure about the private issuers in which they invest, and low levels of liquidity. These private markets have an appropriate role in addressing capital and liquidity needs for certain issuers and shareholders, and we support methods of private capital formation that facilitate growth while, importantly, protecting investors. In particular, existing law appropriately balances the interest in fostering these transactions with investor protection concerns. For example, the Regulation D private placement safe harbor permits sales to accredited investors without the need to provide information, but prohibits general solicitation, limits the number of nonaccredited investors and requires that specified information be provided to nonaccredited investors. Because not all

accredited investors are necessarily sophisticated, the prohibition on general solicitation ensures that investors who do not have any relationship with the issuer or its placement agent are not drawn in through public advertisements.

While technological advancements have caused a proliferation of private platforms to match buyers and sellers of private stock, investor protection concerns such as the lack of transparency, disclosure and liquidity in these markets should be addressed as these markets expand to a larger set of investors. Investments in private companies are highly risky, with significantly greater risk than investing in the public markets, and historically have been limited to investors that can understand, evaluate, and financially bear these additional risks. I therefore have concerns about legislative proposals that could open up these markets in private companies to a larger set of investors without additional investor protection measures. Any proposal to greatly expand the role of private markets must require either: (1) a high level of investor sophistication and a relationship with the issuer or its placement agent such that the investor can consider and understand the risks of the company in which he or she invests, or (2) a sufficient and uniform amount of disclosure so less sophisticated investors understand what they are investing in.

Two recent legislative proposals need to be considered against these threshold criteria. H.R. 2940, the Access to Capital for Job Creators Act, would remove the requirement under Section 4(2) of the Securities Act and Rule 506 of Regulation D that, in order to qualify for an exemption from registration as a private placement (a transaction "not involving any public offering"), there be no general solicitation. The restriction on general solicitation has been a core feature of the private placement exemption since the first court interpretations of Section 4(2), and is an important safeguard to avoid fraud against investors. The restriction on general solicitation is the key limitation which protects the general public from being drawn into the private markets—a market that by its very nature has a high level of risk not suitable for most investors, and does not provide the real-time liquidity of public markets. In fact, in connection with another exemption under Regulation D, Rule 504 (which permits certain offerings of $1 million or less in reliance on State "blue sky" laws), the SEC found that instances of fraud greatly increased when it relaxed the prohibition on general solicitation. As a result, the SEC found it needed to reinstate into Rule 504 elements of the prohibition on general solicitation to prevent the abuses which it can cause.[4]

Additionally, any proposed exemption from registration for "crowdfunding" offerings also needs careful consideration. Allowing entrepreneurs to raise capital through crowdfunding is an important step to encourage new business and growth, however, important investor protections are needed. These types of investments are very risky, and because they may be offered through a general solicitation, less sophisticated investors may be drawn in. Any crowdfunding exemption should therefore include a low limit on total offering size, a low limit on the amount any individual can invest (such as $1,000), and require that issuers disclose sufficient information to ensure that investors understand what they are purchasing.

The Committee also asked me to comment on pending legislative proposals to increase the number of shareholders a private company may have before being required to publicly disclose information. We support a measured increase from the current 500 shareholder level, but believe that public policy concerns regarding shareholder access to information should limit the size of the increase. In particular, we support H.R. 2167, the Private Company Flexibility and Growth Act, which would increase the level to 1,000 shareholders while excluding from the count current or former employees that were issued shares as compensation.

In closing, I applaud the Committee's focus on finding ways to encourage job creation through facilitating capital formation. The reforms contained in the Reopening American Capital Markets to Emerging Growth Companies Act of 2011 reflect a measured approach that would remove the major roadblocks preventing emerging growth companies from raising capital in the public, transparent markets, while avoiding the potential for fraud and investor abuse that may arise from opening up the illiquid and private markets to average investors.

I appreciate the opportunity to testify before the Committee today and am happy to answer any questions you may have.

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[4] SEC Release No. 33-7644 (Feb. 25, 1999).

PREPARED STATEMENT OF EDWARD S. KNIGHT

GENERAL COUNSEL AND EXECUTIVE VICE PRESIDENT, NASDAQ OMX GROUP

DECEMBER 1, 2011

Thank you Chairman Johnson and Ranking Member Shelby. On behalf of the NASDAQ OMX Group, I am pleased to testify on "Spurring Job Growth Through Capital Formation While Protecting Investors."

Capital formation and job creation are in NASDAQ OMX's DNA. Forty years ago NASDAQ introduced the world to electronic markets, which are now the standard for markets worldwide. The creation of NASDAQ introduced sound regulation to the over-the-counter trading. Around NASDAQ grew an ecosystem of analysts, brokers, investors and entrepreneurs allowing growth companies to raise capital that was not previously available to them. Companies like Apple, Microsoft, Oracle, Google, and Intel, all of which are listed on the NASDAQ Stock Market, use the capital they raised to make the cutting edge products that are now integral to our daily lives. As they grew, these companies have created millions of jobs along the way. It is this heritage that is the foundation of my testimony today.

Today, the NASDAQ OMX Group owns and operates the global infrastructure of public markets, markets for securities that are publicly traded and available to all investors. We own 24 markets, 3 clearing houses, and 5 central securities depositories, spanning 6 continents. Eighteen of our 24 markets trade equities. The other six trade options, derivatives, fixed income products, and commodities. Seventy exchanges in 50 countries trust our trading technology to run their markets, and markets in 26 countries rely on our surveillance technology to protect investors, together driving growth in emerging and developed economies. We are the largest single liquidity pool for U.S. publicly traded equities and provide the technology behind 1 in 10 of the world's securities transactions.

To summarize, we believe that regulation is absolutely necessary to support capital formation and protect investors in both the public and private markets. It is, however, particularly critical to the public markets. Significantly, the public markets are best at allocating capital and creating jobs. Therefore, it is absolutely imperative that we strike the right balance in regulating the public markets and avoid losing their benefits.

Recently, Congress has moved forward in its consideration of several proposals that focus on the private company model. Each is briefly described below:

> H.R. 2940: eliminates the ban on solicitation of investors when a company is offering securities under Regulation D.
>
> H.R. 2167: increases the number of shareholders from 500 to 1,000 before a company is required to register with the SEC.
>
> H.R. 1070: increases the offering threshold from $5 million to $50 million before a company must register with the SEC.
>
> H.R. 2930: exempts certain crowdfunding investments from SEC registration.

The first three bills have been well considered and debated, and we have no objection to them. The last bill represents a new and exciting concept, which we look forward to learning more about and sharing views with other market regulators and participants before we reach a final opinion.

While these bills will help the private capital formation markets, my comments today focus on the public markets. Private and public markets play complementary roles. It is ironic that in the debate about these bills about private company markets, supporters have cited challenges facing the public markets—the declining number of U.S. IPOs and the high cost of being a public company—to bolster the case for legislation relaxing the rules for raising private capital.

While we support modernizing rules to embrace new circumstances and technologies, our struggling economy demands more substantive action that goes to the heart of the problem. In other words, as we make it easier for companies to avoid the U.S. public capital markets either by staying private or going overseas to list, we should also deal with structural issues that make our public markets less attractive today. In fact, I submit that Congress would signal a retreat from the public markets if it limits the scope of its action to the private markets.

I'm here today to urge you to take steps to enable NASDAQ to continue our long term commitment to facilitating capital formation while protecting investors and contributing to economic and job growth. We ask for your help in reshaping the rules driving the public markets so that investors and entrepreneurs will continue to view the U.S. capital markets as the most efficient and best regulated markets in the world.

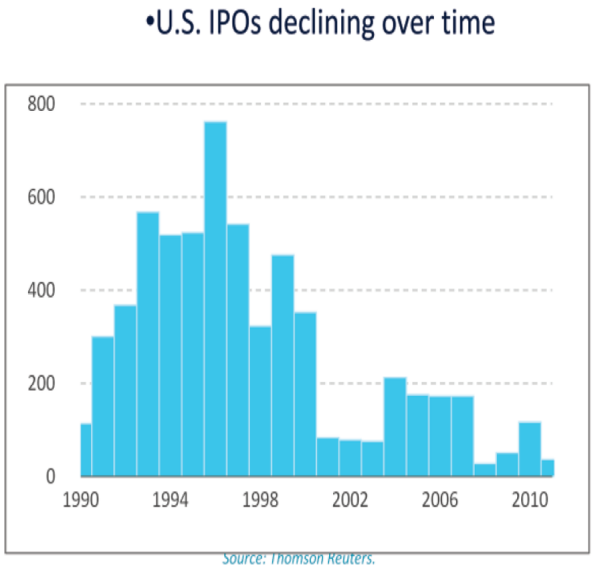
Why Do We Need Public Companies and Markets?

In light of the movement to relieve more companies from the obligations of registration and going public, we think it is time for Congress and regulators to review why we need strong, vibrant public company markets. Some might ask, if companies can access the capital they require in the private markets, why should we be concerned? There are three critical reasons in our view to recommit to the public markets:

1. Efficient pricing and funding of entrepreneurial activity: The value of an enterprise, how much capital it should receive, and at what costs are best determined by a deep competitive market like the public markets. A company that has a clear price set in the open market will attract more investors and lenders to help them fund growth. It is well recognized that companies that do not trade on exchanges are valued at a discount. Companies that do not trade in the public markets must establish their value through *ad hoc* valuation and opaque negotiation. A limited number of potential investors bid for private companies. Financial experts, the IRS, the SEC, and courts recognize that discounts for lack of marketability can range from 30 percent and even higher. Clearly, a company valued 30 percent or more below its true value will not be able to invest, grow and create jobs as quickly.
2. Jobs: A healthy public equity market enables companies to raise capital more efficiently, funding more rapid growth and more jobs. Companies create 90 percent of their new jobs after they go public. An IPO is the best public policy outcome in terms of jobs for the broader economy. A company that has exchange-traded shares can better use its stock as a currency to grow its business and incentivize employees. A successful IPO is a very public signal to other entrepreneurs about the availability of capital financing.
3. Wide availability of investment opportunity: A public listing allows the most diverse universe of investor's access to ownership. This democratization allows employees, individual investors, pensions, mutual funds, corporations, and others to put their capital to work and enjoy the rewards, and risks, of equity ownership.

Condition of the U.S. Public Markets

The United States used to be the market of choice for global IPOs. From 1995 to 2010, listings on U.S. exchanges shrank from 8,000 to 5,000, while listings on non-U.S. exchanges grew from 23,000 to 40,000.



Calls to increase exemptions from SEC registration indicate that excessive regulation is stifling innovation, capital formation, and growth. Prior to the Internet bub-

ble, the U.S. averaged 398 IPOS per year in the early 1990s and there were never fewer than 114 IPOs per year, even during a recession. Following the regulatory changes of the last decade, there has been an average of only 117 U.S. IPOs per year. In 5 of the last 10 years, including 2011, there have been fewer IPOs than in the worst year of the 1990s. In addition to the overall decline in the number of public companies, the average IPO has increased in size as the cost of complying with increased regulation has deterred many smaller and younger companies from going public.

I am not suggesting that the health of the U.S. economy is dependent on the number of companies listing on U.S. exchanges. It is, of course, much more complex than that. But, I would point to two recent academic studies which suggest that the reduction in the availability of IPO capital may have profound consequences for the U.S. economy as a whole. When IPO capital formation is restricted, entrepreneurs are incented to create products which complement existing products of large companies, rather than creating transformational products which change the way we live, work and think. Entrepreneurs are forced to sell their ideas too cheaply in the private markets. Essentially, the NASDAQ ecosystem of the past has been replaced in a "second best" form by the private markets. In the broadest terms, resources are inefficiently allocated, growth is negatively impacted, and the economy falls short of its potential.

As I indicated above, we operate in 50 countries around the world and provide regulatory services in twenty-six. Markets in Australia, Canada, Brazil, and Hong Kong offer levels of efficiency and regulatory integrity that are perceived as world class by investors and issuers. Longstanding rivals to the U.S. markets such as the United Kingdom have also taken significant steps to improve the efficiency and competitiveness of their markets. And that is good for the global economy. However, the U.S. is no longer the top jurisdiction for capital raised via IPOs, ranking second in 2011, and only three of the top 10 IPOs so far this year have been by U.S. firms. In 2010, IPO issuances from the Asia-Pacific region accounted for almost two-thirds of global capital raised. The story is the same for smaller companies too. Venture oriented markets in Australia, Canada and the U.K. have listed 155 companies each raising $50 million dollars or less, while only 44 such companies have listed in the U.S. during 2011.

What Is Hurting the U.S. Public Markets?

Well-intentioned incremental public policy decisions have accumulated over time, that in their totality, serve as major barricades to getting more IPOs in the U.S. Although issues like our litigious legal environment and our outdated tax system impact the decision making in this area, today I will focus on two categories more directly in this Committee's jurisdiction—regulation of public companies and regulation of the exchanges and their competitors. And I would note that many of these conclusions are well supported by two recent Blue Ribbon studies: The President's Council on Jobs and Competitiveness and the IPO Task Force, which arose from the Treasury Department's Access to Capital Conference.

Regulation of Public Companies: Too many times, regulation has been approached with a "one size fits all" solution. Yes, Sarbanes-Oxley comes to mind. As we look back on the enactment of Sarbanes-Oxley in the wake of Enron's collapse, while it can be said that Congress acted quickly and aggressively to restore investor confidence, the bill which was produced did not distinguish between the large companies listed on our Global Select Market, and the small companies listed on our Capital Market. The SEC and PCAOB have continued that approach with rules and legal obligations that usually assume that all public companies are large enterprises that can digest and respond to rules and regulations with the same ease. This is not the case, and it is chasing companies away from our markets and hurting job creation.

We believe it is time for a new approach. We commend to the Committee the October 20, 2011, report of the IPO Task Force entitled "Rebuilding the IPO On-Ramp." This Task Force, whose members are some of the best experts on capital formation and represent diverse interests, set forth a detailed proposal to create a regulatory on-ramp for early stage growth companies, during which disclosure rules and compliance burdens would be phased-in, while maintaining investor protections. The Task Force also made detailed recommendations about how to improve research coverage for smaller companies. These recommendations merit careful consideration.

Market Structure Does Not Help Attract Companies to the Public Markets

We believe that the daily operation of the markets and their increasing complexity hurt efforts to get companies to go public here in the U.S. Today's U.S. markets are increasingly fragmented and volatile. Liquidity in U.S. stocks is dispersed across 13

exchanges, over 40 other registered execution venues, and uncounted other trading facilities. The declining cost of launching and operating electronic order crossing systems has led to a proliferation of decentralized pools of liquidity that compete by offering their owners and customers reductions in fees, obligations, transparency and order interaction.

Consider that today nearly one-third of public company stocks trade 40 percent to 50 percent of their volume away from the exchanges. In the past 3 years the percentage of U.S. market share traded in systems that do not publicly post their bids and offers rose from 20 percent to over 30 percent. Many retail and core investor orders are executed away from the primary exchanges.

We recognize that there are situational benefits and value to some orders trading away from the public. We also recognize that competition between markets has dramatically reduced investors' costs and improved market quality in listed securities through technological and structural innovation. However, the unintended consequences of the market fragmentation has been a lack of liquidity and price discovery in listed securities outside the top few hundred names and a disturbing absence of market attention paid to small growth companies by all market participants, including exchanges.

Such fragmentation of trading creates a thin crust of liquidity that is easily ruptured, as occurred on May 6, 2010. In fact, the SEC and CFTC in their joint "Flash Crash" report pointed out: "The Commission has noted that absent extraordinary conditions such as those occurring on May 6, 2010, retail orders are generally executed by internalizers away from exchanges and without pretrade transparency, exposure or order interaction." Fragmentation and current market structure may be raising investors' costs. In 2010, the U.S., which has perennially ranked first globally for institutional investor costs, fell to fourth in the world, behind Sweden, Japan, and France. Price discovery and available transparent liquidity are essential parts of vibrant market systems.

We believe that, whenever possible, public price discovery should be encouraged to ensure a robust and balanced marketplace. Private transactions serve an important role at times and in those situations should be encouraged—when a customer can get price improvement, or when market impact for larger institutional orders can be minimized. That said, we must also ensure that there is ample liquidity contributing to the critical role of price discovery. Transparency is critical to efficient markets.

Just as our markets continue to evolve and adapt, so must the regulatory structure of our markets. We need to strengthen regulation by modernizing systems and increasing transparency to regulators. We support the development of a consolidated audit trail with real time market surveillance and new regulatory tools to help regulators keep pace with technology advances and other changes in the markets.

Additional steps the SEC should take include adopting modifications to the market data revenue allocation formula to emphasize the value of public quotations.

Finally, we believe that companies should be able to choose the manner in which their shares trade, particularly for smaller companies in the period following an IPO when an efficient and liquid market is still developing.

Small Companies Need a Strong Venture Exchange To Grow and Create Jobs

In our markets the number one source of job creation is entrepreneurship. Just as business incubators nurture small companies until they are ready to leave the security of that environment and operate independently, there should be a space for incubating small public companies until they are ready to graduate to a national listing. The U.S. must create a space for these companies just as our foreign competitors have successfully done.

Canada, the United Kingdom, and Sweden have successful venture markets with significant numbers of listed companies and substantial capital-raising success. These markets list hundreds of small companies that create jobs at a fast rate. Venture market companies regularly grow and then graduate to the main markets in those countries. The U.S. has no equivalent exchange-supported, organized venture market.

In just 5 years, the Swedish First North Market, run by NASDAQ OMX, has grown to 141 listings with a total capitalization of 2.8 billion Euros. Twenty-two First North companies have graduated to the main market since 2006. All of this in a country of 9 million people. The Toronto Stock Exchange's TSX Venture Exchange may be the most successful of these venture markets. The TSX Venture Exchange lists 2,100 companies with a total market capitalization of $37.8 billion and a median size of $4.2 million. And 451 TSX Venture Exchange companies have graduated to the Toronto Stock Exchange since 1999. Graduates account for more than

$87 billion in market capitalization. According to the London Stock Exchange, The London AIM Market has been one of the fastest growing markets in the world for the last decade. They have listed over 1,200 companies, including 234 international listings, some of which are American firms, and 141 AIM Market listings have graduated to LSE's main market. These markets have successfully used special listing standards and adopted innovative market structures targeted towards smaller companies.

BX Venture Market Can Be the U.S. Home for Small Companies. The NASDAQ OMX Group has received approval to create a new listing venue on the former Boston Stock Exchange. The BX Venture Market will have strict qualitative listing requirements, similar to other exchanges, but lower quantitative standards that would attract smaller, growth companies. The availability of the BX Venture Market will facilitate their ability to raise capital to continue and expand their businesses, creating jobs and supporting the U.S. economy. The BX Venture Market will provide a well-regulated listing alternative for companies that otherwise would transfer to, or remain on, the largely unregulated Pink Sheets or OTCBB, where there are no listing requirements, no public interest review, limited liquidity, and limited transparency, or list on junior tiers of non-U.S. markets.

However, under existing structures, these companies will receive little regulatory benefit from opting to subject themselves to these additional requirements. For example, unlike companies listing on other exchanges with higher quantitative listing requirements, they will still be subject to the State's Blue Sky laws. We believe that there should be incentives provided to these smaller companies that list on a public company, such as the on-ramp described in the IPO Task Force Report. We also believe that steps should be taken to limit the fragmentation of trading in these smaller companies.

NASDAQ's Recommendations for Strong Public Capital Markets

Our capital markets require multifaceted actions to help invigorate the atmosphere for entrepreneurs to help their companies' access capital and create jobs. We believe that these reforms would restore the ecosystem that once existed and is necessary to nurture, sustain and grow public companies and reinvigorate the U.S. engine of job growth.

Solution #1: Reform Sarbanes-Oxley

All of the NASDAQ OMX executives who are engaged in selling the U.S. markets to companies around the world tell me, to a person, that Sarbanes-Oxley is the most quoted reason for not listing on NASDAQ. President Obama's own Council on Jobs and Competitiveness has called for sweeping reforms to regulation in this area. The President's Council stated:

> Amend Sarbanes-Oxley (Sox) to allow shareholders of public companies with market valuations below $1 billion to opt out of at least Section 404 compliance, if not to all of the requirements, of Sarbanes-Oxley; or, alternatively, exempt new companies from Sox compliance for 5 years after they go public.

We believe that a further reduction in compliance costs could be obtained if the Section 404(b) examination were allowed to occur every 2 years for exchange-listed companies that are found to have no significant weaknesses.

Solution #2: Reject Expensive and Expansive New Regulations on Public Companies and Reexamine Existing Regulations

Policy makers and regulators must also be careful about imposing new regulations that lack necessity, yet will raise a public company' costs. Congress, the SEC and other regulators should evaluate the global competitive landscape before imposing new regulations.

One example is the recent PCAOB proposal to require public companies to rotate auditors. In 2005 after the PCAOB was created, a hearing was held in the House Financial Services Committee and then-Chairman William J. McDonough was asked about the viability of required auditor rotation. Chairman McDonough wisely rejected the idea then, and it should be rejected now.

Existing regulations should also be reexamined. In that regard, as noted earlier, we believe there is significant merit in the IPO Task Force's idea to ease compliance burdens during a small company's transition to being a public company. Recent regulations that have resulted in a dramatic reduction of research coverage for smaller companies should also be reviewed.

Solution #3: Support a Strong and Vibrant Venture Exchange With Innovative Market Structure for Small Companies

While we are certain the BX Venture Market is needed, we also believe that innovative trading rules are required to make the market successful. Small companies do not trade like big ones. As you look at the trading behaviors of small companies, building and maintaining liquidity can be a constant challenge. When we examine what has worked here and abroad in building liquidity for smaller companies, we believe these stocks should receive the same protections as Regulation NMS securities and that market data should be made widely available through existing data feeds.

The most prevalent listed company concern we hear about equity market structure relates to volatility. It is time for the SEC to consider allowing certain IPO companies, especially smaller companies using the public market to fuel growth, for a period of up to a year, to choose the market structure they feel would best introduce their stock to the marketplace. Empower these IPO companies to restrict the fragmentation that occurs in their stock and causes volatility and limit their trading to a well-regulated, transparent market unless off-exchange trading delivers real price improvement.

The SEC should allow companies to pay for market quality by allowing the exchanges to establish programs to reward broker dealers for committing capital to a stock and meeting rigorous market-quality benchmarks established by the exchange. This has worked in our Nordic markets.

Solution #4: The SEC Should Act on the Market Structure Concept Release and Allow Public Companies To Opt Out of a Fragmented Market

The SEC's thoughtful market structure reform proposals have not moved forward while the agency has been focused elsewhere. Regulators must turn attention back to these proposals. Such action is consistent with the SEC's Congressional mandate to ensure that our markets are open, fair and orderly. Congressional input to regulators will restore this initiative.

Solution #5: Create Jobs by Allowing Companies To Hire the Employees They Need

One issue that we now mention to every Member of Congress and in testimony to every Committee we appear before is legal immigration reform. The United States achieved its economic prominence by inviting the best and the brightest from around the globe to unleash their creative capabilities on American soil and contribute to the American mosaic, culturally, politically, and economically. Immigrants have been some of the greatest contributors to business, science and technology in American Society. Twenty-five percent of technology and engineering companies from 1995 to 2005 had at least one immigrant key founder.

Our economy and NASDAQ itself have directly benefited from the contributions of foreign-born talent. Looking just at the Fortune 500 companies, we found at least 14 active NASDAQ companies that have foreign-born founders. These companies represent over $522 billion in market capitalization and employ almost 500,000 workers.

Legal immigration is a source of economic growth in the United States and NASDAQ OMX is concerned that continued entanglement in the illegal immigration debate will only exacerbate our already anemic economy. Every year we send approximately 17,000 STEM graduate students back to their home countries after educating them here in the finest universities in the world. It is critical that we reform our immigration system to accommodate these graduates. If U.S. companies cannot hire them here, they will hire them for the same job overseas. Therefore, I recommend the following to the U.S. Congress:

- *Debate legal immigration on its own merits:* Do not link legal reform to reform of illegal immigration—Americans are losing jobs and opportunity while one issue drags down the other. American workers, with good jobs, cluster around these highly skilled workers. Achieving a comprehensive solution will take years—years Americans who need jobs do not have.
- *Enact a more flexible and stable regime for Legal Immigration*: Reform must convey economic priorities about job growth and global competitiveness. Increasing H-1B numbers is no longer enough. We need to admit and keep entrepreneurs here so that the creative dynamism of our marketplace has the very best skills and minds. The default should be "yes," not "no."
- *Attack the "job stealing" myth directly:* Opponents of Legal Immigration reforms argue that when a foreign born immigrant gets a job, American graduates are the losers. Research tells a different story. The National Federation for Amer-

ican Policy says that for every H-1B worker requested, U.S. technology companies increase their employment by five workers.

Thank you again for inviting me to testify. I look forward to responding to your questions.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT SUBMITTED BY SENATOR CARL LEVIN

CARL LEVIN
MICHIGAN

United States Senate
WASHINGTON, DC 20510–2202

December 1, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
Washington, DC 20510

Dear Tim:

There are several bills that have been placed on the Senate Calendar that purportedly seek to promote job creation and small businesses by relaxing or modifying the federal securities laws.

I am troubled by these bills, and their Senate counterparts, as drafted.

I understand that you intend to hold a hearing today to address some or all of the issues raised by these bills, and I would appreciate your including the attached statement in the record of that hearing.

Thanks.

Sincerely,

Carl Levin

Carl Levin

PRINTED ON RECYCLED PAPER

Statement of Senator Carl Levin
December 1, 2011

Today's hearing is intended to examine several bills that are now being characterized as small business "jobs" or "capital access" bills. Each of these bills is designed to address a perceived challenge facing small or private businesses, but all of them would eliminate or diminish aspects of the federal securities laws. I thank the Chairman for holding today's hearing, which I hope will explore many of the issues raised by these bills.

These bills, as drafted, reduce investor protections and increase regulatory blind spots. Put simply, the unsubstantiated promise of job creation is being used to justify a weakening of investor protections and regulatory oversight. Some bills can be improved and some cannot.

Collectively, the bills seek to expand the tools businesses have at their disposal for raising capital. The bills approach the issue from four different angles:

Regulation A. The Tester-Toomey bill (S.1544) and its House-passed counterpart would make it easier for companies to conduct public offerings using a streamlined version of the regular SEC registration process called Regulation A, by raising the cap on the dollars that can be raised from $5 million to $50 million. The Reg A process has been effectively abandoned in recent years, and these bills are attempts to revive it as a less-burdensome alternative for smaller issuers.

Raising the threshold to $50 million may be a reasonable method to revive the usage of Reg A, while still ensuring, because of its relatively small size, that it is not abused by large companies seeking to avoid the normal public registration process.

However, in addition to raising the cap, the Tester-Toomey bill also creates a routine process through which the cap would very likely be raised every two years, with no limit. In fact, if the SEC declined to raise the cap, it would have to report its reasons for doing so to the appropriate committees of jurisdiction. The bill language could even be read to remove the discretion of the SEC to lower the cap in the future.

This procedure would allow the cap to be raised well above a level appropriate for small business. Allowing companies to raise well in excess of the proposed cap using the streamlined Reg A process would undermine the normal registration process and the additional protections it provides to investors. Although the SEC could raise the cap now, that authority has not been utilized and companies have completed only a handful of Reg A offerings in recent years.

Congress should ensure that the bill provides an alternative registration process for only smaller offerings, and is not used by larger companies to evade normal investor protections.

Accordingly, the bill should be revised to safeguard the integrity of the Reg A process and retain its focus on small offerings.

A second issue involves the question of liability. Section 11 of the Securities Act of 1933 generally provides strict liability for issuers that make misstatements or omissions of material facts in their prospectuses. Those who aid in the prospectuses' preparation may also be found

liable. Some have raised the concern that it is unclear whether this liability would apply to misstatements or omissions made in Reg A filings. The bill should be revised to clarify that the same liability standards apply to Reg A offerings.

I support raising the cap for Reg A offerings to $50 million, but I believe that we should protect the integrity of Reg A and retain its focus on providing an easier alternative for small offerings.

Crowd-Funding. A second set of bills would authorize so-called "crowd-funding," which would essentially allow companies to use the internet and potentially unregulated intermediaries to raise funds from ordinary investors. Most crowd-funding proposals would allow a corporation to advertise itself on a third party "intermediary" website, and solicit small investments from a large number of retail, meaning unsophisticated, investors, without the normal burdens of registering with the SEC.

These intermediary websites typically provide a list of several different investment options. This approach is similar to the approach used in philanthropy and micro-loan operations in which artistic endeavors, charities, or small entrepreneurs use the Internet to advertise their projects and solicit a large number of small donations.

The current House and Senate versions of this proposal would create a "crowd-funding" exemption from federal and state securities laws, which would allow small businesses to advertise publicly on the Internet and raise money from a large number of investors.

Both versions would significantly weaken federal and state securities laws by opening up a huge loophole for securities offerings to the investing public. Regulators, practicing securities lawyers, and others have expressed concerns about whether the bills retain adequate protections for ordinary investors. They note that these types of small, unregistered investments are precisely the same types of instruments used by unscrupulous fraudsters in "boiler room" cases over the decades. As currently drafted, these bills could end up sanctioning an online investment casino generating huge losses for small investors.

My key concerns with the House bill in particular include the following.

1) It would create a new unregulated class of broker-dealers. The "intermediaries" that operate the websites or otherwise facilitate investments in the companies would be acting much like an SEC-registered broker-dealer, but would not be required to register or operate like one. There would be virtually no SEC or state oversight of the websites or the companies that run them. Yet, these intermediaries are the only entities who can perform basic due diligence to ensure that the companies seeking funding are real business enterprises, and not shams.

2) The proposed investment and income restrictions are inadequate. The bill would allow a company to accept investments of as much as $10,000 or 10% of an investor's income. A person losing $10,000 or 10% of his annual income would be a very meaningful loss. Yet, both because of their newness and their relative freedom from regulation, companies using this crowd-funding exemption could easily fail. There are also no safeguards to prevent an investor from plowing $10,000 or 10% of their income into several crowd-funded companies. This is of particular concern given that the intermediaries typically would allow users to view and invest in a large number of companies. In addition, as we

saw during the financial crisis, investors may certify that they have greater incomes than they do, but the bill contains no effective requirement for income verification.

3) Investing in new companies is often a high-risk proposition that is not suitable for many investors. Federal securities laws and the rules of the self-regulatory organizations currently prohibit broker-dealers from selling customers investments that are "unsuitable" for the investor. For unsophisticated investors, investments in these early-stage companies, which are among the riskiest of all investments, are unlikely to be "suitable," but this bill would circumvent that investor protection. Even worse, the disclosures mandated by the bill are inadequate to meaningfully warn potential investors of the inherent risks.

4) The bill would also preempt state securities regulatory protections, an approach that the recent financial crisis has shown was ill-advised. State securities regulators often have the best information and sensitivity to investment frauds harming their residents. They are much-needed cops on the beat, and we should not unnecessarily limit their abilities to protect their citizens.

While crowd-funding proposals sound enticing, Congress should be leery of weakening bedrock investor protections, and make sure that this niche funding opportunity does not open the floodgates to fraud. I understand that Senators Merkley and Bennet may be working on a proposal that may permit crowd-funding with more appropriate investor safeguards, and I look forward to evaluating it.

Shareholder Ceiling. Currently, companies with more than $10 million in assets and 500 or more shareholders must register and make periodic filings with the SEC, which also means that they must comply with Sarbanes-Oxley financial controls and other federal securities laws. A third set of bills would increase the number of shareholders that private companies may have before being required to go public and register with the SEC from 500 to up to 2,000 shareholders, depending upon the bill.

Some have argued that high registration and compliance costs, along with low investor demand for smaller public offerings, make it difficult for companies at or near the 500 shareholder limit to go public. Some very large companies that are near the 500 shareholder limit may buy-back their shares or engage in other transactions so as to ensure they don't hit the trigger. These corporations would like to raise the shareholder limit to make it easier for them to avoid having to comply with filing requirements and other regulatory protections.

H.R.2167 would raise the trigger from 500 to 1000 shareholders. The bill would also exclude from the count all accredited investors, such as pensions, insurance companies, university endowments, hedge funds and mutual funds, and employees of the issuing company, which would mean that most shareholders would not be counted at all. A similar Senate bill would also raise the trigger from 500 to 2000 shareholders. Another, much more limited version (S.556), which was introduced by Senators Hutchison and Pryor, would raise the shareholder number trigger to 2,000 solely for banks or bank holding companies.

It is unclear how helping corporations with large numbers of shareholders avoid federal securities laws would help create jobs or help small businesses.

Venture capitalists have said that they do not think that raising the shareholder limit would be especially helpful to startup companies. And the research indicates that the costs associated with SEC registration and Sarbanes-Oxley compliance are *not* major factors when businesses decide whether or not to go public. Far from helping the IPO market, some have expressed concerns that this bill could further inhibit the return of a healthy IPO market.

I have not heard from any small businesses seeking to raise the cap on all companies. Rather than being a small business concern, there is substantial evidence to suggest proposals to increase the thresholds for all companies are being pressed by larger private companies that are seeking to avoid SEC registration. The trading platforms where large "private" issues are now being traded outside of regulated exchanges are also pushing for this bill. And some experts suggest that as many as half of all public companies might be able to fall under a raised cap.

It is difficult to imagine how helping large businesses avoid federal oversight, transparency, and investor protections produces jobs or assists small business. In fact these bills may be counterproductive in that they will make our markets less transparent and less attractive for investment. One of the great strengths of our markets is its transparency.

Further, a substantial debate is going on over how to count the number of shareholders, including how to count investment pools or securities held in street name, which may allow firms to evade the limits. The SEC staff is currently studying this issue and there is no reason to jump the gun before they come out with their findings.

Setting the appropriate thresholds for when a company is large enough, and has enough shareholders, so that it should register with the SEC and provide basic levels of financial transparency is critical to healthy capital markets. These issues deserve thoughtful study and informed debate, which we have not yet had. The bills to raise the shareholder threshold are premature, and threaten harmful consequences for US capital markets and investor protections.

Advertising. The fourth and final set of bills relate to advertising issues. Regulation D is designed to exempt small private offerings from SEC registration so long as the issuer sells the securities to only accredited investors, such as wealthy individuals, pensions, insurance companies, mutual funds, and hedge funds. Sales to non-accredited investors are strictly limited.

When relying on Reg D, issuers are prohibited from "general solicitation," in other words, publicly advertising the offering of their securities. H.R.2940 would allow issuers relying on Reg D to publicly advertise their securities so long as the resulting sales are to accredited investors.

While this concept sounds sensible, loosening the general solicitation prohibition was tried before and failed. Ultimately, the SEC re-imposed the restriction because the increased leniency was "abused by perpetrators of microcap fraud." Some would suggest that Congress should ignore this real-life test of the importance of the general solicitation prohibition. We shouldn't.

This proposal could open the door for Internet solicitations, billboards along the highway, and mass mailings promoting risky, opaque investments to the masses. It is an invitation to fraud and there is no evidence to suggest that it would promote jobs or small business.

I thank Chairman Johnson for holding this hearing today and for the opportunity to share my concerns. I look forward to working with my colleagues on ways to promote small businesses and job creation while maintaining investor protections and oversight of our financial markets.

LETTERS SUBMITTED BY SENATOR JOHN THUNE

JOHN THUNE
SOUTH DAKOTA

COMMITTEES
AGRICULTURE, NUTRITION & FORESTRY
BUDGET
COMMERCE, SCIENCE & TRANSPORTATION
FINANCE

United States Senate
WASHINGTON, DC 20510–4105

http://thune.senate.gov

December 5, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing,
and Urban Affairs
United State Senate
Washington, D.C. 20510

The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Johnson and Ranking Member Shelby:

I request that the Access to Capital for Job Creators Act (S. 1831) be included on the agenda for the Committee's next mark-up. This legislation would provide small businesses another way to access private capital by allowing them to widely seek funds from the entire pool of Securities and Exchange Commission (SEC) accredited investors without requiring them to go through the full SEC registration process.

Currently, federal securities law prohibits general solicitation, creating legal uncertainty for companies seeking capital. My bill, S. 1831 removes the general solicitation prohibition contained in the Rule 506 of Regulation D exemption from full SEC registration for companies to sell more than 5 million dollars in securities under the Securities Act of 1933. By limiting the purchases to a select market of sophisticated investors accredited by the SEC, as my bill does, adequate investor protection is provided given the requirements set forth by the SEC. Companies would still be required to file notification with the SEC through Form D that includes information as to the companies' executive officers and stock promoters, and would still be subject to all of the SEC's anti-fraud provisions.

The general solicitation prohibition severely hampers the ability of small businesses to raise capital. This legislation is an important step in helping America's small businesses and entrepreneurs raise capital from accredited investors in order to expand and create jobs. In fact, S. 1831 is supported by small businesses, entrepreneurs, and investors. I have enclosed letters of support for S. 1831 and ask that they be included in the record for the December 1, 2011 hearing of the Committee, "Spurring job growth through capital formation while protecting investors."

Passage of this legislation would be an accomplishment that I believe can be done with broad bi-partisan support, as evidenced by its overwhelming support in the House of Representatives, where it was passed on November 3, 2011 by a vote of 413-11.

I respectfully request that S. 1831 be included on the agenda for the Committee's next mark-up and that the enclosed letters of support be included in the record of the Committee's December 1, 2011 hearing.

Sincerely,

JOHN THUNE
United States Senate

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November 30, 2011

The Honorable Richard Shelby
Ranking Member, Committee on Banking, Housing and Urban Affairs
United States Senate
304 Russell Senate Office Building
Washington, DC 20510

Dear Ranking Member Shelby:

We write today to express our support for the pending bill sponsored by Senator John Thune S. 1831, the Access to Capital Job Creators Act.

An often-repeated truism of the U.S. economy is that small businesses – generally defined as those with fewer than 500 employees – account for about 70 percent of net new job creation. But recent research has shown that, in fact, new businesses are the U.S. economy's true engine of job creation. Businesses less than a year old contribute an average of 3 million new jobs each year. To be sure, existing small businesses and larger firms are important, too. But if the policy target is job creation, new business formation is the bull's-eye.

Regrettably, America's entrepreneurial economy is faltering. According to a recent BLS report on entrepreneurship, after increasing at a relatively steady rate for more than a decade, the number of new businesses created annually peaked in 2006, and then began a precipitous decline – a decline accelerated by the recent recession. Even more alarming, the new businesses that are being formed are creating fewer new jobs. If such patterns persist, over the next ten years new firms will likely create 7.5 million fewer jobs, suggesting that the United States may face chronic unemployment of 9 percent or higher for many years.

The Access to Capital Job Creators Act will meaningfully enhance the circumstances for new business formation and survival by facilitating access to critical investment capital. S. 1831 revises rules issued in SEC section 230.506 of title 17, that prohibitions against general solicitation or advertising contained in section 230.506 will not apply to offers and sales of securities, provided all purchasers are accredited investors, removing unnecessary costs to which start-ups and other small businesses seeking additional investors are currently subject.

Reductions of such costs will promote survival and growth of new and small businesses, improving broader economic circumstances and accelerating job creation.

Sincerely,

Rob Nichols

Rob Nichols
President and CEO
Financial Services Forum

November 15, 2011

The Honorable John Thune
United States Senate
Washington, D.C. 20510
Via electronic mail

Dear Senator Thune:

On behalf of the Small Business & Entrepreneurship Council (SBE Council) and its nationwide membership of 100,000 small business owners and entrepreneurs, we are delighted that you have introduced S. 1831, the "Access to Capital for Job Creators Act." SBE Council strongly supports this timely and critical piece of legislation that will benefit America's entrepreneurs.

Access to growth capital is a significant challenge for many entrepreneurs. The uncertain economic climate, and competition for capital at the global level have made conditions much more difficult for U.S. entrepreneurs in their efforts to raise capital. Therefore, it is vital that elected officials and policymakers work to identify and remove impediments that hinder capital formation as well as the entrepreneur's access to potential pools of capital. Indeed, outdated regulatory barriers are making it more difficult for entrepreneurs to approach prospective funders to secure critical resources for growth.

The "Access to Capital for Job Creators Act" is a long-overdue solution that will widen the pool of potential funders for entrepreneurs. By lifting the antiquated and onerous "solicitation prohibition" contained in Rule 506 of Regulation D of the Securities Act of 1933, promising enterprises can approach "accredited" investors outside of their personal networks to seek and secure the capital they need to compete and grow. This rule modification is a sensible reform step, as proven by the lopsided vote that S. 1831's companion bill in the House received.

Our economy will improve once entrepreneurs are provided the tools, opportunities and incentives they need to hire and invest. While Washington must work on an array of issues to boost optimism and improve the business environment, S. 1831 is a significant step that will help entrepreneurs with one of their key challenges.

Senator Thune, thank you for your leadership and enduring support of America's entrepreneurs. Please let SBE Council know how we may help advance your legislation into law.

Sincerely,

Karen Kerrigan
President & CEO

SBE Council • 2944 Hunter Mill Road • Suite 204 • Oakton, VA 22124 • 703-242-5840
www.sbecouncil.org
Protecting Small Business, Promoting Entrepreneurship

November 30, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Jack Reed
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Mike Crapo
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Johnson, Ranking Member Shelby, Senator Reed and Senator Crapo:

We are investors, startups and incubators writing to support S. 1831, the "Access to Capital for Job Creators Act." This law will ease regulations around general solicitation and advertising in the context of issuer private placements under Rule 506 of Regulation D, provided that the ultimate purchaser qualifies as an accredited investor.

According to the Kauffman Foundation, startups are responsible for nearly all net job creation in the United States. The primary constraint to the creation of even more jobs is seed capital for new startups. And there is an abundance of experienced investors with the capital and desire to invest in new startups. But general solicitation and advertising regulations obstruct sophisticated investors from finding and funding young companies throughout the U.S.

S. 1831 will accelerate the creation of new jobs across the U.S. because it allows startups to raise capital and access advice without moving to a startup hub to find investors. It will also continue to protect inexperienced investors by requiring purchasers to be accredited.

To be most effective, this bill, or any other legislation designed to encourage greater access to capital, should include language to codify existing SEC precedent that excludes incubators, social networks, and other venues where startups meet investors from broker-dealer registration, as long as those venues do not receive transaction-based compensation. These new venues afford investors with a level of protection that investments found through personal relationships cannot provide. For example, investors can use these venues to observe the interest, diligence and reactions of other experienced investors as they consider an investment opportunity.

As the President's Council on Jobs and Competitiveness reported on October 11, 2011:

> "Recently, there has been the emergence of 'angel' investors and networks that have also played a crucial role in the initial funding for companies. The Council recommends clarifying that experienced and active seed and angel investors (and their meeting venues) should not be subject to the regulations that were designed to protect inexperienced investors."

This bill would fulfill the Council's recommendations and we urge the Senate to enact this legislation and amendments, accelerating the creation of new companies and new jobs across the United States.

Sincerely,

The following Investors, Incubators and Startups

INVESTORS

Jonathan Abrams
Founder of Friendster

Marc Andreessen
Founder of Netscape

Steve Case
Founder of AOL

Matt Cutts

Angus Davis
Founder of Tellme

Sky Dayton
Founder of Earthlink

Chris Dixon
Founder of Hunch

Bill Gross
Founder of Idealab

Christopher Heivly
Founder of Mapquest

Fred Hsu
Founder of Oversee.net

Karl Jacob
Former CEO of Keen

Mitch Kapor
Founder of Lotus

Nitin Khanna
Founder of Saber

Charlie Kindel
Former GM at Microsoft

Josh Kopelman
First Round Capital

Max Levchin
Founder of Paypal

Don McLagan
Former CEO of Compete

Farhad Mohit
Founder of Shopzilla

Steve Newcomb
Founder of Powerset

Chamath Palihapitiya
Former VP at Facebook

Hadi Partovi
Founder of Tellme

Gil Penchina
CEO of Wikia

Ariel Poler
Founder of Topica

Howie Rhee
Center for Entrepreneurship,
Duke University

Eric Ries
Founder of IMVU

Dan Shapiro
Founder of Ontela

Matt Shobe
Founder of FeedBurner

Leonard Speiser
Founder of Bix

David Tisch

George Zachary
Charles River Ventures

INCUBATORS

Founder Institute
Nationwide

Startup Weekend
Nationwide

500 Startups
California

AngelPad
California

Hackers and Founders
California

Hub Ventures
California

i/o ventures
California

Idealab
California

Imagine K12
California

Kicklabs
California

Junto
Illinois

Masschallenge
Massachussetts

Project Skyway
Minnesota

Launch Pad Ignition
New Orleans

Triangle Startup Factory
North Carolina

The Brandery
Ohio

Betaspring
Rhode Island

Capital Factory
Texas

StartupBus
Texas

Tech Wildcatters
Texas

BoomStartup
Utah

STARTUPS

Adility Advertising	Adverti.se Advertising	AngelList Startups	Art.sy E-Commerce
Artsicle E-Commerce	Cake Health Health	Chromatik Education	CodeLesson Education
Coffee & Power E-Commerce	Commagere Ventures Games	Contactually CRM	Curebit Enterprise Software
DuckDuckGo Search	Earbits Music	ecomom E-Commerce	Everyme Mobile
Farmeron Agriculture	FastCustomer Mobile	FeeFighters Payments	Fitocracy Health
Freshplum Analytics	Geeklist Recruiting	Getaround Transport	GoSpotCheck Mobile Commerce
GreenGoose Health	Humanoid Cloud Computing	Invested.in Ventures for Good	invino Food and Beverages
InvoiceASAP Mobile Payments	Kaggle Machine Learning	LaunchRock Sales and Marketing	LawPivot Legal
LendFriend Financial Services	Locu Restaurants	Lovely Real Estate	Manpacks E-Commerce
Massive Health Health	MedicalRecords.com Health	NetPlenish Search	OcuSpec Video Games
Postling Small Businesses	PowerInbox Email	Rapportive Email	Rentabilities E-Commerce
Rentcycle E-Commerce	Rentjuice E-Commerce	Rewardli Performance Marketing	Ricochet Labs Social Games
Scan Sales and Marketing	Second Life Virtual Worlds	ShoePrivee Fashion	Simply Measured Business Intelligence
Social Rewards E-Commerce	Socialize Mobile	Spinnakr Small Businesses	Teamly Enterprise Software
Udemy Education	UserVoice Customer Service	Veenome Image Recognition	VidCaster Video
Vidyard Video Streaming	Vungle Advertising	Wishery Customer Service	Zaarly Mobile Commerce

LETTER SUBMITTED BY R. CROMWELL COULSON, PRESIDENT AND CEO, OTC MARKET GROUPS, INC.

OTCMarkets

December 8, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Building
Washington, D.C. 20510

The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Building
Washington, D.C. 20510

Dear Chairman Johnson and Ranking Member Shelby:

On behalf of OTC Markets Group Inc. ("OTC Markets Group"), I am writing in response to the hearing held by the Committee on Banking, Housing and Urban Affairs (the "Committee") on December 1, 2011 entitled: "Spurring Job Growth Through Capital Formation While Protecting Investors," (the "Hearing"). The issues covered at the Hearing are of the utmost importance to the thousands of smaller U.S. companies that are traded by broker-dealers on our platform.

As further discussed below, we strongly support[1] the following proposals:

1) S. 1831, seeking to eliminate the ban on general solicitation for private securities offerings under Regulation D. In addition to our support of this measure, we recommend that any solicitation, advertising or promotion of secondary market trading of these and other securities be conditioned on public availability of adequate current information regarding the issuer, as defined in Rule 144 under the Securities Act of 1933 (the "Securities Act"). For non-SEC reporting issues, public availability should include disclosure on a publicly accessible internet website.

2) S. 1824, seeking to raise from 500 to 2,000 the shareholder threshold for any company to be required to register with the SEC. We recommend that any company exceeding a pre-determined number of non-affiliate shareholders should be required to provide adequate current information to those shareholders.

3) S. 1544, seeking to raise the offering threshold under Regulation A from $5 million to $50 million. Regulation A supports the goals of disclosure and transparency by requiring

[1] In October, we were asked to provide our insight to the House of Representatives' Subcommittee on Capital Markets and Government Sponsored Enterprises as they considered the merits of the House versions of these bills: H.R. 2930, the crowdfunding bill; H.R. 2940, eliminating the ban on general solicitation to accredited investors in a Rule 506 private offering; H.R. 1965, raising for banks or bank holding companies the number of holders of record of any class of securities that will trigger SEC registration from 500 to 2,000; and H.R. 2167, raising the SEC registration threshold for all companies from 500 to 1,000 holders of record. We have also vigorously supported H.R. 1070, raising to $50 million the limit for an unregistered offering under Regulation A.

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an offering document that includes the information set forth on SEC Form 1-A. Regulation A promotes public disclosure outside of the typical SEC reporting structure, providing one example of the many ways in which small company public disclosure can be achieved without the burdens of SEC reporting.

4) S. 1791, seeking to exempt crowdfunding offerings of up to $1 million from SEC registration.

This letter primarily addresses the issues of disclosure, regulation and market structure as they relate to the OTC market, as these concepts were raised by several witnesses at the Hearing. We advocate for an open and transparent OTC marketplace, which includes a competitive environment where broker-dealers can participate in the market and get the best prices for investors. Specifically, we strongly support a regulatory regime that (i) promotes disclosure in the OTC market, (ii) regulates company insiders and promoters, (iii) properly defines shareholder threshold rules, and (iv) avoids trading monopolies and ensures competition among broker-dealers for transactions in OTC securities. As the operator of the primary OTC equity marketplace, we are best equipped to fully discuss the operation of the OTC market and the ramifications of some of the ideas put forward by the witnesses at the Hearing.

Introduction to OTC Markets Group

OTC Markets Group operates OTC Link, the world's largest electronic marketplace for broker-dealers to trade OTC securities. The OTC Link platform supports a network of competing broker-dealers that provide investors with the best prices in over 10,000 OTC securities. Our technology platform has transformed the OTC market into an open, transparent and connected marketplace where investors can efficiently trade through the regulated broker-dealer of their choice.

Our platform categorizes the wide spectrum of OTC-traded companies into three tiers: OTCQX – The Intelligent Marketplace for the Best Companies; OTCQB - The Venture Marketplace; and OTC Pink – The Open Marketplace. Our tiered system permits companies to choose the level of disclosure they wish to provide to investors, and allows investors and regulators to identify the amount and quality of information companies provide.

The companies quoted on our platform include development stage enterprises, technology companies, community banks and established manufacturers. In each of the past two calendar years, an average of 75 companies that grew and matured while trading on the OTC marketplace subsequently listed on a senior U.S. exchange, making us the primary incubator for exchange listed companies. OTC Link currently enables trading in over 3,000 SEC registered companies current in their reporting, over 2,000 companies that report to a foreign regulator, over 500 banks that report to their U.S. banking regulator, and many smaller U.S. companies that have not met the current 500 shareholder threshold for mandatory SEC registration, but may make public disclosure through the internet, securities manuals, or other sources. Our platform also includes the securities of more than 600 non-SEC reporting issuers that provide public information to investors through our OTC Disclosure and News Service. Our understanding of this community of small, publicly traded issuers makes us uniquely qualified to comment on the bills and associated proposals discussed at the Hearing.

Public Information Availability Improves Capital Formation and Protects Investors

OTC Markets Group has long been a proponent of issuer disclosure and trading transparency. The SEC staff has been slow to realize that the internet changed the landscape regarding investor access to information. As a result, regulators must change their approach and begin incentivizing the market to operate in an open and transparent manner, rather than in private.

We agree with Justice Brandeis, who noted that "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[2] We have long espoused that philosophy as we work to increase the quality and quantity of real-time information available to investors in OTC securities.

We are a free and open society, and as such we should encourage an open marketplace for capital and incentivize market participants to operate in full view of the public. Open and transparent activity is always superior to opaque and closed environments. Activities conducted in public are open to scrutiny from the public, the press and the police. This transparency deters fraud and increases efficiency. The public and the press catch many more fraudsters than the police can catch alone, but they can only see information if regulation encourages its public exposure. For example, the string of frauds perpetrated by Chinese companies listed on NASDAQ was first brought to light by attentive members of the public and the press. In addition, the Madoff fraud lasted for so long in part because Madoff's entire operation was conducted in the dark, without the light of any public disclosure. If the public and press had access to the Madoff information, perhaps a calamity could have been avoided. As these examples indicate, although the SEC has the regulatory and legal means to gain access to non-public information, it is naïve to believe they will efficiently provide effective protection from bad behavior and fraud without the watchful eye of public scrutiny.

We operate an open and transparent platform where broker-dealers determine what to quote based on customer demand, and we see a wide variety of companies on our platform at all stages of business development. In 2007, we began categorizing OTC issuers on the basis of disclosure levels in order to incentivize disclosure and inform investors. In 2010, over 95% of the approximately $144 billion of dollar volume traded through our marketplace was in companies that provide adequate current information to investors. Companies that provide no information represented less than 2% of total dollar volume. The companies on our platform that purposefully "Go Dark" and do not provide any financial information to the public are publicly marked with a "stop sign" logo. Investors are clearly warned that information may not be available.

The SEC's Opaque Approach is Harming Capital Formation and Investors

The SEC's approach to regulation in capital raising and secondary trading of smaller companies has typically represented an outdated approach that has led to much of the capital formation process occurring in the dark alleys and private clubs of finance. This misguided view ignores the development of the internet and the ability of all investors to easily access and share information.

[2] Louis D. Brandeis, Other People's Money and How the Bankers Use It (1914).

The SEC staff's current reasoning includes four principal ideas that harm small business capital formation and hurt investors:

1) Private offerings and secondary trading of restricted securities should be hidden from public view;

2) Unsophisticated investors are best protected by limiting information availability regarding private offerings;

3) SEC registration and reporting under the Securities Exchange Act of 1934 (the "Exchange Act") is the only method for companies to provide high-quality disclosure and financial reporting to investors; and

4) Small company trading should move away from competing broker-dealer's providing liquidity as a service for investors and towards an exchange-type agency auction model.

The written testimony of Meredith Cross alludes to the SEC staff's views. Ms. Cross cites to the Comment Letter from the Investment Companies Institute to the SEC dated October 9, 2007, which warns that unlimited general solicitation would "make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes." The comment Ms. Cross cites is misguided. The transparency provided by general solicitation and advertising, done in conjunction with the public disclosure of adequate current information regarding the issuer, can only improve the efficiency of the capital formation process. Public disclosure allows the public and press to identify "problem" offerings. Limiting offerings to private communications allows promoters to hatch fraudulent schemes in the dark, away from public scrutiny.

Another SEC staff viewpoint, reflected in many no-action letters, advocates putting pricing and offering documents related to private placements behind passwords and firewalls. Ms. Cross cites SEC no-action letters that (i) require investors to provide personal information to unrelated parties prior to gaining access to any information and (ii) limit other market participants from accessing pricing information. This approach moves information away from public view, and creates fundamentally flawed market dynamics with negative consequences. Investors are forced to trade in opaque, closed markets, without easy access pricing information or the advantages of open competition. SEC staff guidelines can allow fraudsters to gain access to an investor's information before disclosing anything to the investor, and to control which investors are ultimately permitted to view the information. Often, password protected websites restrict investors through confidentiality agreements, which prevent them from sharing their conclusions with other investors.

The brokerage industry is generally a capable gatekeeper with "know your customer" and customer suitability requirements. For markets to work efficiently, investors should have easy access to pricing and disclosure regarding all types of securities. Investors that are not qualified to participate in an offering can easily be identified prior to the initiation of any purchase or sale. For example, a broker-dealer may deem a certain investor not sophisticated enough to purchase options, but that investor is at least permitted to view the option terms and prices. Without adequate public disclosure and price transparency, unsophisticated investors will never gain the required knowledge to trade effectively.

The SEC staff should update its regulation of small company capital formation to:

1) Encourage and incentivize the public disclosure of restricted offerings;

2) Maximize the public availability of information, even regarding securities certain investors are not qualified to purchase;

3) Support multiple ways for small companies to provide high-qualify information to investors using the internet; and

4) Provide fair and equal regulation of exchanges and OTC broker-dealers so that different business models employed by execution service providers, including those that produce liquidity as a service through principal trading with customers, can equally compete for investor orders. The more faith investors have that they are seeing all pertinent information about a company, the more likely they are to invest in that company. This allows small companies to grow, create jobs, and support the economy.

General Solicitation and Crowdfunding

We support S. 1831, the "Access to Capital for Job Creators Act," and the disclosure proposals outlined above can apply to the private securities market. It is widely accepted that emerging companies should have access to accredited investors in order to fuel their growth, and accredited investors should be afforded every opportunity to find the best investment opportunities. Allowing general solicitation and advertising to accredited investors removes an unnecessary hindrance to small company capital formation, growth and hiring.

Similar considerations lead to our support of S. 1791, the "Democratizing Access to Capital Act of 2011." The type of crowdfunding permitted by this bill would allow entrepreneurs in the start-up phase to reach out to their communities and raise capital from a larger pool of investors, while giving non-accredited investors access to legitimate investment opportunities. In fact, we would support taking the concepts of general solicitation and crowdfunding one step further, with the proper protections in place to ensure investor protection.

Allowing general solicitation only when a company makes adequate current information publicly available (as that term is used in Securities Act Rule 144), will increase information availability to investors and the efficiency of capital allocation. Such a change would promote additional public disclosure from all companies considering a private placement. The increased transparency would benefit current and potential investors, regulators and other market participants, and would provide capital raising opportunities to companies willing to provide public disclosure of their operations and financial condition. To that end, the SEC should also specifically allow for the public distribution of prices from broker-dealer managed transactions in restricted or "Rule 144A" securities.

The goal of the SEC's Regulation D should be to restrict private offerings to sophisticated investors who can understand the risks and withstand potential losses. That goal can be accomplished without mandating that all private sales take place in the dark. Congress and the SEC can allow unsophisticated investors to access information concerning private transactions while still restricting such investors from participating in private placements. The goals of investor protection and the provision of disclosure can be simultaneously met.

We also agree with Professor Coffee's comments at the Hearing that any active solicitation related to crowdfunding should be conducted by a licensed broker-dealer that can be monitored and regulated accordingly.

Greater Public Disclosure is the Best Fraud Prevention

Our focus on increased disclosure has made us keenly aware of the situations in which a lack of disclosure leads to opportunities for fraud, particularly involving private placements in publicly traded companies and in promotional activities. We strongly support regulation providing that any advertising relating to private placements, and any promotion regarding secondary trading, should be conditioned on (i) adequate current information being made publicly available and (ii) the public disclosure regarding a promoter and the person or entity that hired such promoter.

Specifically, any person or entity involved in the promotion of a security should be required to publicly disclose their identity and the actions they have taken to promote a specific security. This regulation should apply to the issuer and any person distributing the solicitation. This would allow for easy identification of a subset of corporate insiders that should be regulated when interacting with the markets, and would help ensure compliance with restrictions on promotional activities. We proposed such a rule[3] to the SEC in 2006, and despite hundreds of supportive comments the SEC has not yet taken any action.

Securities Act Rule 144 includes a definition of adequate current public information that would be appropriate for the disclosure requirements described above. These rules would incentivize disclosure by non-reporting issuers, and would dramatically increase the amount and quality of disclosure available to investors and regulators. Moreover, the increased disclosure incentivized by these rules may reduce instances of fraud under Exchange Act Rule 10b-5, which applies to the purchase and sale of any security.

Shareholder Threshold Rules

S. 556 and S. 1824 seek to raise from 500 to 2000 the threshold number of shareholders requiring a bank or company, respectively, to register with the SEC. These bills acknowledge that the burdens of SEC registration and reporting can be stifling to a developing business. It is clear that many small companies, and the economic growth they create, would be negatively impacted by the expense of SEC registration or the restructuring necessary to remain below the current 500 shareholder limit. We agree with these contentions.

Several witnesses at the Hearing noted that small companies operate, and trade, in a manner entirely different from large companies. For these companies, SEC reporting is not the only viable method of encouraging public disclosure. For example, the OTC Markets Group tiered categorization system organizes companies by the level and quality of the disclosure they provide. Our data shows increased liquidity in companies that provide adequate current information. The increased liquidity is a natural, market-driven incentive for issuers to provide more public disclosure, and we have seen increased levels of disclosure in each of the five years since we instituted our tiered structure.

[3] *See* http://sec.gov/rules/petitions/petn4-519.pdf

Holder of Record v. Beneficial Holder

The Hearing included significant discussion regarding use of the "holder of record" standard or the "beneficial holder" standard for purposes of determining a company's number of shareholders. The current 500 shareholder threshold is calculated based on the holder of record standard, and we strongly advocate leaving that standard in place in connection with S. 556 and S. 1824. Two main factors lead to our vigorous support of the holders of record standard.

First, many companies cannot accurately calculate their exact number of beneficial holders. Rule 13d-3 under the Exchange Act defines a beneficial owner as any person who directly or indirectly has voting or investment power over a security. That meaning can and does encompass more than just a typical individual holder of one or more company shares. The federal securities laws require shareholders to disclose beneficial ownership of SEC registered companies when such ownership reaches certain levels. That disclosure allows SEC registrants to report relevant information relating to their significant beneficial owners. Shareholders of non-SEC reporting companies, however, are not required to disclose ownership at any level, leaving the subject companies with no mechanism for determining who their beneficial holders are. Many companies attempting to calculate beneficial ownership resort to an imprecise combination of their transfer agent's records combined with the results of a broker search. However, the prevalence of individual and single-entity investors choosing to be "objecting beneficial owners" for purposes of a broker search makes this method unreliable. It is important to note that even SEC registered companies are not required to report their exact number of beneficial shareholders, presumably also due to the near impossibility of accessing the necessary information. The holder of record standard is easily discoverable and provides a more accurate and administratively feasible guideline.

Second, raising the shareholder threshold from 500 to 2,000 but changing to the beneficial holder standard would actually cause many more companies to be subject to SEC registration. An informal survey of companies quoted on the OTC Link platform indicates that the ratio of beneficial holders to holders of record is often as high as 10:1. A company with 300 holders of record is not subject to SEC registration under the current rules. That same company may have 3,000 beneficial shareholders, which would require SEC registration under a new standard of 2,000 beneficial holders. Thus, the purpose of S. 556 and S. 1824 would be defeated, and in fact harmed, by moving to a beneficial holder standard.

We note the testimony of Meredith Cross concerning the SEC's study of companies that would be impacted by the move from a holder of record to a beneficial holder standard. We do not have access to the SEC's data, however we urge the Committee to carefully analyze the SEC's results when they are available, and to work with the SEC to develop an appropriate solution. It is imperative to gain a full understanding of the potential impact of a change to the beneficial holder standard prior to instituting such a change.

The need for outside shareholders to receive adequate current information can be met without requiring Exchange Act registration and reporting. Congress and the SEC can easily set a threshold number of non-affiliate shareholders that would trigger a provision requiring the information required for non-reporting companies under Rule 144 to be disclosed directly to record or beneficial holders.

In the event that Congress and the SEC ultimately determine to move to a beneficial holder standard, we propose including a safe harbor provision based on the holder of record

standard. Companies with less than 500 holders of record that provide adequate current public information as defined in Rule 144 should be able to opt out of SEC registration as long as they continue to comply with the provisions of the safe harbor. This may alleviate the unintended consequence of making more companies subject to SEC registration, while simultaneously encouraging additional public disclosure.

Efficient Market Structure for Small Company Trading

OTC Markets Group took great interest in the Hearing testimony concerning the appropriate market structure to support trading in small and developing companies. Securities markets and marketplaces are a key component of the capital formation process, as improvements to investors' ability to monetize their investments in the future makes the current cost of raising capital lower. We agree with the assertion of the witness from NASDAQ that small companies and large companies do not trade alike.

We strongly disagree, however, with NASDAQ's suggestion that the best way to meet the needs of small companies is to require that they be traded solely on exchange platforms. It should be noted that when NASDAQ was a thriving marketplace for small companies it operated as a quotation system, not a registered stock exchange.

NASDAQ makes the outrageous suggestion that to save companies from the evils of market "fragmentation," public companies should be permitted to choose a sole, exchange-listed venue on which to have all broker-dealers send their trades, thereby effectively creating a trading monopoly for the chosen exchange. It is apparent that NASDAQ's concerns regarding "fragmentation" are simply an attempt to subvert competition.

Avoidance of Trading Monopolies

A monopolized trading venue would stand against the basic American market principles that the owner of a security can choose which broker to trade through, and that the broker can choose what exchange or broker-dealer to trade with. Fair competition among brokers and dealers, among markets, and between exchange markets and OTC markets are well-worn principles in the fabric of American securities markets. These ideals bring investors fair pricing and deep liquidity.

We are concerned that similar anti-competitive, monopolist traits appear in other developing markets for small company securities. We specifically refer to the private company trading markets frequently in the news today, where issuers may try to control the platform on which their shares are traded. This effectively gives the private platforms a monopoly.[4] Congress should consider the questionable legality of the practice of restricting investors to trading a specific company's shares through one broker-dealer or exchange. Rather than attempting to frighten investors and regulators into granting investor trading monopolies, trading venues would better serve investors by building platforms that deliver the superior product, price and service needed to attract business through choice and competition.

[4] These platforms generally charge between 3% and 5% commissions, with high minimums. Investors would clearly benefit from price the price competition that would be generated by the involvement of multiple broker-dealers.

Small Company Trading v. Large Company Trading

Having just one trading process for a company's shares would also ignore the different trading needs of large and small company investors. The appropriate market structure for different size companies should be tailored to the type of investors they attract.

The major exchanges, NYSE and NASDAQ, have designed their listing standards to meet the needs of the large, passive investors, such as pension and index funds, that are the majority owners of the largest U.S. corporations. These investors recognize the naturally declining percentage of stock owned by management teams and directors as companies grow larger. This presents an agency-principal conflict that leads exchanges to institute heightened listing requirements regarding corporate oversight, complicated operational controls, and increased corporate governance processes. These changes provide adequate protection to large institutional investors buying large-cap companies, but they can place a heavy burden on smaller companies.

By contrast, small company shares are more likely to be owned by those that run the business, such as entrepreneurs, founding families, private equity, or venture capital firms. At small companies, management and directors are generally substantial investors, thus already aligned with long-term shareholder value creation. These investor-managers do not need or desire the complex organizational structures required by an exchange listing. NASDAQ was once the home for these small, developing OTC companies, but has now moved on to focus on competing with NYSE for S&P 500 issuers. NASDAQ's shift in strategy left a void for small company trading that is now being filled by OTC Markets Group through the OTC Link platform.

Small company trading markets are geared towards stock pickers and other active, informed investors, rather than major pension funds and index driven investors. Small company investors need to thoroughly research and understand the companies in which they invest, and marketplaces should be designed to serve these intelligent investors. Our marketplace has long been the home for educated investors – in fact, Warren Buffett's biographer noted that "One of his favorite sources was the Pink Sheets, a weekly printed on pink paper, which gave information about the stocks of companies so small that they were not traded on a stock exchange. Another was the National Quotation book, which came out only every six months and described stocks of companies so miniscule that they never even made it into the Pink Sheets. No company was too small, no detail too obscure."[5]

Congress and the SEC should craft rules and regulations that create incentives for small companies to provide the information intelligent investors require to adequately value securities, without overburdening these companies with big company corporate governance.

The OTC Markets Group Open, Transparent & Connected Marketplace

The OTC Link platform is an interdealer quotation system -- a distributed network with fully attributed broker-dealer prices and counter-parties disclosed. At the SEC's request, we are in the process of registering our OTC Link system as an Alternative Trading System, or ATS. Contrary to the perception of some witnesses that our market has limited liquidity and limited transparency, in 2011, over $200 billion of dollar volume will be traded through our platform, and we estimate that 97% of such volume will be in companies providing current information. A majority of those companies are SEC reporting or also listed on a non-U.S. exchange.

[5] Alice Schroeder, The Snowball: Warren Buffett and the Business of Life, page 173-174 (2008).

Companies that choose to distinguish themselves based on the disclosure they provide or the quality of their business can do so through our tiered system, with the best companies qualifying for the OTCQX tier.

Over 95% of all priced broker-dealer quotes in OTC equity securities in the U.S. are published on OTC Link, with the remaining few quotes on FINRA's OTCBB™. The OTCBB was originally established as an automated quotation system for penny stocks to satisfy the Congressional mandate to the SEC set forth in Section 17B of the Exchange Act. Section 17B dictates that the automated quotation system for penny stocks must be operated by a registered securities association or a national securities exchange in accordance with applicable SEC rules.

To include the platforms fostering the most dynamic innovation in the trading of small company shares by broker-dealers, Section 17B should be expanded to include ATSs. Like a registered securities association or a national securities exchange, each ATS must be registered with the SEC and is subject to SEC oversight. OTC Markets Group can fulfill the Section 17B mandate to provide price transparency in small company trading, while providing adequate technology to our broker-dealer subscribers and ensuring widespread distribution of our market data.

Our market data is now consolidated and distributed through most major distribution networks, including Bloomberg L.P. and, recently, the NYSE SuperFeed™ platform. Market data sales are a significant portion of our business, and we have excelled at providing fair access and widely distributing our information to all market participants. FINRA has proposed a Quote Consolidation Facility ("QCF") that would collect, in real-time, the quote prices published on OTC Link. FINRA would then sell that quote data back to its members and other users as part of a data feed. The data taken by FINRA under the QCF would be data that we currently aggregate and sell as part of the OTC Markets Group proprietary data feed that includes a consolidated best bid or offer for all OTC equity securities. This data is already easily consolidated and widely distributed on our data feed.

Moreover, FINRA would include our OTC market data in a market data feed that contains NMS securities. FINRA already engages in this practice with the market data it generates from the OTCBB. Commingling OTC market data with NMS market data mistakenly signals to investors that OTC securities have the same characteristics as NMS securities. A small OTC issuer does not have the same risk profile as an S&P 500 company, a point that should be made apparent at every opportunity. We inform investors by consistently indicating that our platform supports OTC securities, and by including our tiers in our market data feed. This allows investors to understand the inherent risk. Comingling also forces investors only interested in market data for NMS securities to purchase OTC market data as well. This adds cost to many investors without providing any related benefit.

The QCF amounts to FINRA using its regulatory authority to take our intellectual property and use it for FINRA's financial gain, while serving no legitimate regulatory or public purpose. If the SEC believes we are not making our market data available in a fair and consistent manner, they can require us to register as a Securities Information Processor, or SIP. The QCF is comparable to the suggestion that the exchanges be given monopolies over small company trading. In each instance, the increased regulation leading to monopolies would be unnecessary, costly, and harmful to investors.

Forcing all small and large companies to trade in the same manner would disadvantage the developing, growth companies that Congress intends to support through the capital formation bills now being considered by the Committee. In fact, allowing exchange venues to monopolize trading would cut against the goals espoused by this very Committee when commenting on the proposal to establish a National Market System in 1975. The report noted that "In the Committee's view the fundamental goals of a national market system include (1) providing an investor or his broker with the ability to determine, at any given time, where a particular transaction can be effected at the most favorable price and (2) creating an incentive for multiple market makers to deal in depth on a continuous basis. In other words, in the national market system, investors should be able to obtain the best execution of their orders and be assuring that because of open competition among market makers the total market for each security is as liquid and orderly as the characteristics of that security warrant."[6]

The Committee's 1975 report places a significant value on an open, competitive environment in which broker-dealers can get the best prices for their investors, while generating liquidity for the marketplace. Not surprisingly, broker-dealers tend to gravitate to marketplaces, such as the OTC Link platform, that provide attribution and easy access to competitors' liquidity. While the SEC typically, and appropriately, focuses on the role of individual investors in the trading process, the majority of the liquidity available to execute investor orders comes from principal trading by securities firms. The liquidity that principal trading adds to the market is vital to sustaining viable markets for small company shares. This liquidity also gives small investors increased opportunities to easily buy and sell the stocks of their choosing. It is important for Congress and SEC to recognize the invaluable role of broker-dealers in the small company trading process, and to keep their best interests at heart when crafting regulation. Congress should take a careful look at the whether the ongoing attempts by the SEC and FINRA to apply NMS-type rules to the OTC market are justified.

Conclusion

The small company capital formation bills under consideration by the Committee are essential for spurring economic growth. Our interest in the development of small companies stems from our long-term involvement in the public secondary trading of small company securities. Decreasing the costs of raising capital, and supporting an investor base while still growing, are admirable goals that can be achieved by the combination of effective regulation and the maintenance of a vibrant OTC marketplace.

The OTC Markets Group platform provides an environment in which America's small companies can become the job creation engines we need, without onerous SEC regulation or exchange listing requirements. The SEC reporting structure is not the only answer for encouraging disclosure and transparency. Small company disclosure can be regulated in the form of adequate current information requirements and an OTC market structure that incentivizes companies to provide increased information to the marketplace. Similarly, exchange listing requirements such as complex corporate governance standards are vital for large company trading, but inappropriate and overly burdensome for smaller companies. Market structure is not one size fits all, and we provide a tailored trading alternative suited to the specific needs of America's growth companies.

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[6] S. Rep. 94-75, Securities Acts Amendments of 1975, Senate Report (Banking, Housing and Urban Affairs Committee) April 14, 1975, at page 12.

Please contact me if you would like any additional information, and thank you for considering our comments. I look forward to working with you as the small company capital formation initiatives move through your Committee and the full Senate.

Sincerely,

R. Cromwell Coulson
President and CEO, OTC Markets Group Inc.

cc: Members of the Committee on Banking, Housing and Urban Affairs

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STATEMENT SUBMITTED ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, the American Bankers Association (ABA) appreciates the opportunity to submit this statement for the record on shareholder registration thresholds. ABA represents banks of all sizes and charters and is the voice of the Nation's $13 trillion banking industry and its two million employees.

ABA members are grateful to Senator Kay Bailey Hutchison and Senator Mark Pryor for introducing S. 556, which would address this issue.

The topic of this hearing today is an important one for a great many community banks whose shareholders include generations of families and local community members. Many of these banks have faced a rule that has remained in place for over 40 years without being updated. That rule, which implements parts of the Securities Exchange Act of 1934, causes small, local banks to be subject to the same costly reporting requirements as large public firms, even though banks are already comprehensively regulated and subject to other disclosure requirements.

The Exchange Act has two tests to determine whether a company must register its securities with the Securities and Exchange Commission (SEC) and thus become subject to the SEC's significant reporting requirements: $10 million in assets and 500 shareholders of record. Since 99.5 percent of banks reach the asset threshold for registration as a public company, the only meaningful test of whether a bank should be registered as a public company is the number of shareholders. But while the asset threshold has been increased tenfold since 1964, the shareholder threshold has stayed the same.

Banks that are nearing the 500 shareholder threshold may have nowhere to turn to raise capital they need to meet the credit needs of their communities. And once registered as a public company, banks are subject to disproportionately high financial and opportunity costs when compared to other smaller public companies. These regulatory requirements and costs eat into capital and limit banks' ability to make loans in their communities.

ABA has long advocated that the shareholder threshold be increased, an update that is long overdue. ABA strongly supports the bill introduced by Senator Hutchison which would update the shareholder threshold for registration for banks to 2,000, providing much-needed regulatory relief. This change would enable banks to deploy their capital in lending rather than spend it on regulatory requirements that provide little incremental benefit to the banks, shareholders, or the public.

In addition, this legislation would address the deregistration threshold for banks, which can occur when the number of shareholders decreases and banks that were once public can become private. Currently, the number of shareholders of record must fall below 300 shareholders before the business can deregister. Raising the threshold for deregistration along with the threshold for registration makes a lot of sense from both a business and corporate governance perspective.

The urgency to address this issue increases every day. Over the last several years, banks have faced increased regulatory costs. This is exacerbated by bank regulators piling on new requests for even greater levels of capital. Combined with hundreds of new regulations resulting from the Dodd-Frank Act, these pressures are slowly but surely strangling traditional banks, handicapping their ability to meet the credit needs of their communities. Increasing the shareholder limit would open up an avenue to bring capital into small local institutions.

ABA is very interested in working with the Committee to move legislation forward that can accomplish these important changes, so that banks can continue to reach out to their local communities for the capital that is vitally important in our efforts to increase lending in their communities.

As this Committee well knows, banks are part of a highly regulated industry governed by numerous statutes and regulations affecting almost every aspect of banking activity. Most banking institutions are regulated by two agencies: a primary Federal regulator and, in the case of State chartered banks, by the State regulator, as well. Significant financial and other information regarding every bank and savings association can be publicly viewed on the Web site maintained by the FDIC. All banks are required to make annual reports available to both their customers and investors. Most provide financial and other information to investors through their company Web sites. The advantage to the local banks from increases in the registration and deregistration thresholds would not be a lack of transparency, since keeping shareholders and the public fully informed about the bank's performance is essential to its presence as a community bank. Rather it is a reduction of regulatory burdens and reporting requirements that pose a disproportionate burden on smaller institutions.

There are two points we would like to make today:

- Community based banks are disproportionally burdened by the 500 shareholder threshold; and
- A higher shareholder threshold more accurately reflects public company status.

I. Community Banks Are Disproportionally Burdened by the 500 Shareholder Threshold

Banks with 2,000 shareholders or less are local businesses with local shareholders. These institutions had median revenue of $9.15 million and a median 182 full-time employees as of the second quarter 2011. It is common for these banks to receive little or no analyst coverage, have a limited trading market, and attract little—if any—institutional investment. Accordingly, any small benefit that banks may receive from being public is significantly undermined by the disproportionately high costs of regulatory compliance for small companies. It is well documented that the costs of being a public company are disproportionately borne by smaller public companies.[1] Furthermore, banks are already subject to comprehensive regulation and disclosure requirements by the banking regulators while other small companies are not.

These costs come directly out of capital, reducing banks' ability to lend. Capital is the foundation for all lending and is also critical to absorb losses when loans are not repaid. In fact, $1 worth of capital supports up to $10 in loans. The downward spiral of the economy has created losses and stressed capital levels; consequently, the bank regulators have pushed banks to raise their capital-to-assets ratio. Not surprisingly, when the economy is weak, new sources of capital are scarce. Capital may become impossible for banks that are nearing the 500 shareholder threshold. The result is that these banks are forced to shrink—by making fewer loans in order to raise their capital-to-assets ratio. Clearly, it would be better to turn to additional investors to put new capital in place that would support additional community lending.

Unlike other small businesses, most banks are broadly held by shareholders in their communities. Even without ever offering shares publicly, many banks have seen their shareholder base grow as successive generations distributed their stock holdings among their descendents. These factors exert significant pressure on banking organizations and other affected companies to reduce the number of shareholders in order either to avoid registration requirements or to deregister.

Due to the increasing costs of being a registered public company, a number of small businesses, including some of our member banks, have determined that deregistration is in the best interests of their shareholders. However, companies that wish to deregister must either have less than $10 million in assets or less than 300 record shareholders. Since 99.5 percent of banks have greater than $10 million in assets, banks who wish to deregister must somehow reduce their shareholder base below 300 record shareholders.

Reducing the number of record shareholders can be costly. Stock buybacks, reverse stock splits and the attendant legal costs are particularly expensive for small businesses. In addition, these transactions can have negative consequences for local communities. As much as local financial institutions would like to get out from under the heavy weight of SEC registration, they often have no desire to reduce the number of shareholders, especially if that means disenfranchising the localized ownership that makes these banks members of the community.

ABA member Daniel Blanton, President and CEO of Georgia Bank Financial Corporation, recently testified on this before the SEC Advisory Committee on Smaller Public Companies:

> We are reluctant to [deregister] because the Bank was founded on the belief that the Augusta [Georgia] area needed a locally owned and operated, relationship-based bank. Most of our shareholders live within our market and all but a few do some business with the bank. This localized ownership is quite common at community banks across the U.S. Often times, investing in the local bank is the only remaining investment members of a community can still make.

In other words, not only do institutions benefit from having close relationships with local investors, but those same investors looking for ways to invest locally ben-

[1] *See, generally,* Foley and Lardner, "The Cost of Being Public in the Era of Sarbanes-Oxley" (August 2, 2007) available at *http:/www.foley.com/publications/pub_detail.aspx?pubid=4487;* "Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies", SEC Release No. 33-8666 (March 3, 2006) [71 FR 11090].

efit from having local institutions to invest in that are not franchises or businesses otherwise related to companies that are headquartered outside the community. In addition, banks that cannot reasonably go private due to a large shareholder base could be forced to merge with a larger partner in order to spread out the cost of compliance. Such regulatory-induced mergers or disenfranchisement should be avoided as a matter of public policy.

II. A Higher Shareholder Threshold More Accurately Reflects Public Company Status

In 1964, when Section 12(g) was enacted to expand the registration and reporting requirements beyond companies traded on a national exchange, Congress understood the need for the regulation to be scaled and thus limited the reach of the provisions to ensure that "the flow of proxy reports and proxy statements [would] be manageable from a regulatory standpoint and not disproportionately burdensome on issuers in relation to the national public interest served."[2] Companies are not considered to have a large enough public market presence to be subject to significant reporting under the Exchange Act unless both the asset and shareholder thresholds are met.

In the more than 40 years since Section 12(g) was adopted, the size of the investing market has grown substantially, as have the number of corporations and the number of investing shareholders. A small corporation today with a small investor footprint is significantly different from what it was 40 years ago. While the shareholder threshold of 500 at one time may have been an accurate reflection of a public market, it no longer is today.

For the banking industry, the shareholder number is the only meaningful Section 12(g) measure because 99.5 percent of all banks have assets in excess of $10 million. Banks have large dollar assets because the loans they make are considered assets while the deposits they hold are considered liabilities. To give the Committee some perspective, the bank regulators define a small bank for purposes of the Community Reinvestment act as an institution with less than $1 billion in assets,[3] so virtually all banks that are considered small, in at least one context, will exceed the asset size parameter of the Section 12(g) test.

Over time, the asset measurement standard set by Congress in 1964 has been adjusted "to assure that the burdens placed on issuers and the Commission were justified by the numbers of investors protected, the size of the companies affected, and other factors bearing on the public interest, as originally intended by Congress."[4] Nonetheless, while the asset size parameter has been increased tenfold from the $1 million level initially required in 1964 to $10 million in 1996 to reflect the exponential growth in the securities market, the 500 shareholder threshold has never been adjusted to reflect the dramatic increase in the number of securities investors, although the SEC noted in 1996 its intention to consider updating the threshold.

Conclusion

Community based banks are focused on developing and maintaining long-term relationships with customers—and shareholders—many of which live in and around their communities. The antiquated 500 shareholder rule limits banks' ability to reach out to their communities for the capital that is greatly needed to support lending. Updating this rule will provide another valuable capital tool as banks work to improve the economy in our local areas and in the whole of the United States.

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[2] Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (adding Section 12(g), among other provisions, to the Exchange Act); .S. Rep. No. 88-379, at 19 (1963).

[3] *See, e.g.,* 12 C.F.R. §228.12(u).

[4] Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, SEC Release No. 33-8666 (March 3, 2006) [71 FR 11090, 11097].

LETTER SUBMITTED BY CHAIRMAN JOHNSON FROM WILLIAM F. GALVIN, SECRETARY OF THE COMMONWEALTH, COMMONWEALTH OF MASSACHUSETTS

The Commonwealth of Massachusetts
Secretary of the Commonwealth
State House, Boston, Massachusetts 02133

William Francis Galvin
Secretary of the Commonwealth

November 28, 2011

The Honorable Timothy P. Johnson,
Chairman, Senate Committee on Banking, Housing and Urban Affairs
United States Senate
136 Hart Senate Office Building
Washington, DC 20510

Re: S.1831, The Access to Capital for Job Creators Act

Dear Chairman Johnson:

The Secretary of the Commonwealth of Massachusetts is charged with the responsibility to administer the Massachusetts laws by means of the Massachusetts Securities Division. I write in my capacity as the chief securities regulator for Massachusetts to oppose S. 1831, and to warn of dangerous consequences if the bill is adopted in its current form.

I. Removing the ban of general solicitation in offerings under SEC Rule 506 will lower the quality of information in the securities markets and will make investors vulnerable to fraud

The bill takes the ill-advised step of removing the restriction on general solicitation of investors that in non-public offerings that are made under SEC Rule 506, so long as actual sales are limited to accredited investors, as defined by the SEC. This change would dismantle a key protection that is provided under the securities laws. Under current law, in order for a seller of securities to offer securities to the broad public, the offering must be registered with the SEC, and disclosure must be provided by means of a prospectus. Non-public offerings must be sold in private placements that do not involve general solicitation.

The current exemption provided under SEC safe harbor Rule 506 creates a clear demarcation between registered public offerings and private placements. It also keeps publicity about risky non-public offerings out of the public marketplace. Removing the restriction on general solicitation in offerings that are exempt under SEC rules will create a real and foreseeable risk that some issuers will put false and distortive information into the broad public market. This will degrade the information that is in the public market

for securities, because many sellers of limited offerings have a strong incentive to over-promote and hype their securities.

The requirement that public securities offerings must be registered is at the heart of the Securities Act of 1933. Under the Act, public offerings must be registered with the SEC, and a legally-required prospectus must be used to provide disclosure to investors. This registration requirement has for decades been a safeguard against fraud. The registration requirement has protected investors and markets well by mandating that specific, factual, and accurate information must be provided to potential investors and the marketplace. These protections are further reinforced by the prospectus liability provisions that apply to companies that issue securities and control persons of those companies. To maintain the integrity of this system, we urge that Congress not permit general solicitation in Rule 506 offerings.

II. The bill includes language that will create an uncontrolled exemption from securities registration, and will undermine key SEC tools to stop fraudulent offerings

Section 2(a) of the Sen. 1831 would remove the ban on general solicitation not just for offerings sold under SEC safe-harbor Rule 506, but for all non-public offerings sold under Section 4(2) of the '33 Act. This language amending Section 4(2) is extremely dangerous because it allows general solicitation to be used in an exempt offering, but without any requirement that the issuer follow SEC rules, and, in particular, without any requirement that sales must be limited to accredited investors.

The amendment to the statutory Section 4(2) exemption would create an exemption -- with no restriction on general solicitation --for transactions by an issuer not involving a public offering. This broad new statutory exemption will create tremendous uncertainty about which offerings will actually be required to register with the SEC and which ones can use the exemption for non-public offerings. We foresee that many transactions that traditionally have registered with the SEC, and that should be registered, will in the future be sold under the 4(2) exemption as amended. This will degrade the quality of the public information about these offerings because no prospectus or registration statement will be required, and it will open a new door into the marketplace for fraudulent offerings.

Unregistered offerings create very real risks for retail investors. State and federal regulators have seen a variety of fraudulent and high risk offerings that have been peddled to retail investors. We anticipate that fraud operators will take full advantage of the expanded Section 4(2) exemption to avoid registration if Section 2(a) of the bill is adopted.

The amendment to Section 4(2) will undermine one of the SEC's most effective tools to shut down unlawful and fraudulent offerings. Under current law, the SEC can seek a stop order against an unregistered public offering because it violates the registration requirement of the '33 Act. If Section 2(a) of Sen. 1831 is adopted, the issuer of an unregistered public offering could defend itself against an SEC action by asserting that it

is conducting an offering under Section 4(2) of the '33 Act. Because the offering is not being made under an SEC safe harbor rule, the issuer does not need to show that the purchasers are required to be accredited investors; instead, the issuer can simply assert that the offering is a non-public offering because the purchasers are investors who can fend for themselves in making their investment decision. This change would require the SEC to dispute with the issuer whether the purchasers could, in fact, fend for themselves in the transaction, or it would require that the SEC bring its case on the basis of actual securities fraud, a slower and more difficult case to prove. The consequence of this change is that the SEC will lose a key tool to quickly shut down unregistered public offerings.

If you have questions about this letter or my office can assist in any way please contact me or Bryan Lantagne, Director, Massachusetts Securities Division at (617) 727-3548

Very truly yours,

William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts

LETTER SUBMITTED BY BARRY E. SILBERT, FOUNDER AND CEO, SECONDMARKET, INC.

November 30, 2011

Chairman Tim Johnson
United States Senate Committee on
Banking, Housing & Urban Affairs
136 Hart Senate Office Building
Washington, DC 20510

Ranking Member Richard C. Shelby
United States Senate Committee on
Banking, Housing & Urban Affairs
304 Russell Senate Office Building
Washington, DC 20510

Dear Members:

I am writing to urge passage of the legislation under consideration at the "Spurring Job Growth Through Capital Formation While Protecting Investors" hearing before the Senate Banking, Housing & Urban Affairs Committee on December 1, 2011.

I believe that all of the bills being considered are important for our country's entrepreneurs and will help improve access to capital for growth-stage companies, community banks and other small businesses. At a time when our lawmakers, policymakers and regulators debate how best to create new jobs, passage of these bills will directly impact startup growth and could have a major impact on job creation, our country's economy and American global competitiveness.

In particular, I wish to focus on two of the bills that warrant immediate passage by this Congress:

1. "**The Private Company Growth and Flexibility Act**" (S. 1824), which modernizes the so-called 500 Shareholder Rule that compels private companies to become public reporting companies once they have exceeded 499 shareholders and have more than $10 million in assets. This important legislation would increase the threshold from 500 to 2,000, while also exempting from the shareholder count current and former employees who received equity under an exempt equity compensation plan.

The pay structure at startups 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. Companies often prefer to give equity in lieu of cash compensation because startups generally need to conserve capital in order to grow their businesses. Option holders, in fact, are exempted from counting under the 500 Shareholder Rule, 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 are counted towards the 500 shareholder cap.

Thus, 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.

Significantly, the 500 Shareholder Rule also negatively 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 will have access to the investment opportunity.

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 under Rule 506 of Regulation D, provided that the ultimate purchaser qualifies as an accredited investor.

Under many of the existing SEC private placement exemptions, only accredited investors are eligible to purchase private company stock. The prohibition against general solicitation and advertising requires that issuers and intermediaries have a pre-existing relationship with the accredited investor in order to make offerings available. In fact, if a non-accredited 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 non-accredited 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.

I wholeheartedly believe the problems facing growth-stage companies in this country must immediately be addressed, and these straightforward bills are steps in the right direction.

Sincerely,

Barry E. Silbert
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STATEMENT SUBMITTED BY THE BIOTECHNOLOGY INDUSTRY ORGANIZATION

Thank you for the opportunity to submit a written statement to the Senate Committee on Banking, Housing, and Urban Affairs. BIO represents more than 1,100 innovative biotechnology companies, along with academic institutions, State biotechnology centers, and related organizations in all 50 States. Entrepreneurs across the biotech industry are conducting groundbreaking science and are deeply invested in treating the severe illnesses that families around the Nation and world face.

Biotechnology has incredible potential to unlock the secrets to curing devastating disease and helping people to live longer, healthier, and more productive lives, but the barriers that small biotech companies encounter on a daily basis raise some important questions: Would we rather see the next generation of breakthrough cures discovered by researchers in New Jersey or New Delhi? Do we want the jobs associated with this groundbreaking science to go to workers in San Francisco or Shanghai? If we want more scientific breakthroughs that allow us to enjoy a high quality of life—indeed, breakthroughs that save the lives of our loved ones—then shouldn't we put in place policies that encourage innovation?

Biotech leaders must deal with the day-to-day challenges of running small businesses. Of great import in the biotechnology industry is the constant struggle to find working capital. It takes 8 to 12 years for a breakthrough company to bring a new medicine from discovery through Phase I, Phase II, and Phase III clinical trials, on to FDA approval of a product. The entire endeavor costs between $800 million and $1.2 billion. For the majority of biotechnology companies that are without any product revenue, the significant capital requirements necessitate fundraising through venture capital firms. Unfortunately, due to the high-risk nature of our industry, venture capital firms are turning elsewhere to make their investments.

A recent survey conducted by the National Venture Capital Association found that 41 percent of venture capital firms have decreased their investments in the biopharmaceutical sector in the past three years. Additionally, 40 percent of venture capitalists reported that they expect to further decrease their biopharma investments over the next 3 years. Therapeutic areas that affect millions of Americans will be hit by this change in investment, including cardiovascular disease, diabetes, and cancer.

Additionally, venture capital firms are affected by the commitment that other countries are putting into their biotech industries. Forty-two percent of venture capitalists surveyed said they already have health care investments outside of the United States, while 44 percent foresee significant investment increases forthcoming in emerging powers in Asia. Such a decline in venture capital will hinder our companies from making it onto the public markets where later stages of research are funded for large-scale and expensive clinical trials. Fewer initial public offerings will result in a decrease in job growth.

While the biotechnology industry faces significant challenges, we nonetheless have the ability to deliver the next generation of cures and treatments to the bedsides of patients who desperately need them while at the same time creating a healthier American economy. The 1.42 million Americans directly employed by biotech are driven to treat and heal the world, but in order for them to be able to do so, Congress must remove the barriers to innovation that we face. Innovation in biotechnology leads to the medical breakthroughs that cure and treat devastating diseases like cancer and Alzheimer's and allow real people to see their grandkids graduate from college or walk their daughters down the aisle.

Congress has the opportunity to help speed lifesaving cures and treatments to patients by removing burdens to innovation in our industry. Below are some proposals that Congress has been considering that will help alleviate some of the financial struggles that our companies face.

SEC Regulation A (Direct Public Offerings)

Regulation A, adopted by the SEC pursuant to Section 3(b) of the Securities Act of 1933, was created to provide smaller companies with a mechanism for capital formation with streamlined offering and disclosure requirements. Updating it to match today's market conditions would provide an important funding source for small biotechnology companies.

Regulation A allows companies to conduct a direct public offering valued at less than $5 million while not burdening them with the disclosure requirements traditionally associated with public offerings. The intent of Regulation A was to give companies which would benefit from a $5 million influx (*i.e.,* small companies in need of capital formation) an opportunity to access the public markets without weighing them down with onerous reporting requirements.

However, the $5 million offering amount has not been adjusted to fit the realities of the costs of development and Regulation A is mostly not used by small companies today. The current threshold was set in 1992 and is not indexed to inflation, pushing Regulation A into virtual obsolescence. As it stands, a direct public offering of just $5 million does not allow for a large enough capital influx for companies to justify the time and expense necessary to satisfy even the relaxed offering and disclosure requirements.

Regulation A could have a positive impact for small biotechnology companies if its eligibility threshold was increased from $5 million to $50 million while maintaining investor protections. This increase would allow companies to raise more capital from their direct public offering while still restricting the relaxed disclosure requirements to small, emerging companies. Regulation A reform could provide a valuable funding alternative for small biotech startups, giving them access to the public markets at an earlier stage in their growth cycle and allowing them to raise valuable innovation capital.

The Small Company Capital Formation Act, H.R. 1070, which would raise the Regulation A eligibility threshold from $5 million to $50 million, passed the House in November. Senators Tester and Toomey have introduced companion legislation, S. 1544, in the Senate. This bill would provide an important avenue for small biotech companies to raise innovation capital. BIO thanks both Senators for championing this issue, and we look forward to working with them to pass this meaningful legislation.

SEC Reporting Standard (Shareholder Limit)

Although the SEC in general monitors public companies, the agency also keeps tabs on private companies when they reach a certain size. Modifying the SEC's public reporting standard would prevent small private biotechnology companies from being unnecessarily burdened by shareholder regulations.

Once a private company has 500 shareholders, it must begin to disclose its financial statements publicly. Biotechnology companies are particularly affected by this 500 shareholder rule due to our industry's growth cycle trends and compensation practices. Currently, the IPO market is essentially closed to biotechnology, leading many companies to choose to remain private for at least 10 years before going onto the public market. This long timeframe can easily result in a company having more than 500 current and former employees, most of whom have received stock options as part of their compensation package. Under the SEC's shareholder limit, a company with over 500 former employees holding stock, even if it had relatively few current employees, would trigger the public reporting requirements. Exempting employees from any shareholder limit is a minimum necessary measure to ensure growing biotech companies are able to hire the best available employees and compensate them with equity interests, allowing them to realize the financial upside of a company's success.

Also, including accredited investors in the private company shareholder count does not serve the intended purpose of protecting retail investors. The SEC recognizes that accredited investors are a unique class that does not require the same level of protection as other investors. By including them in the 500 shareholder limit, growing private companies are forced to rely primarily on institutional investors because they need to maximize funding without triggering the limit. This excludes retail investors, whom the SEC was originally trying to protect, from taking part in this process.

Increasing the shareholder limit above 500 would relieve small biotech companies from unnecessary costs and burdens as they continue to grow. As it stands, the limit encumbers capital formation by forcing companies to focus their investor base on large institutional investors at the expense of smaller ones that have been the backbone of our industry. Further, it hinders a company's ability to compensate its employees with equity interests and negatively affects the liquidity of its shares.

BIO applauds Senators Toomey and Carper for introducing S. 1824, the Private Company Flexibility and Growth Act, which would increase the shareholder limit from 500 to 2,000 and exempt employees from the count. Representative Schweikert has introduced similar legislation, H.R. 2167, in the House. Increasing the shareholder limit and exempting employees are measures that, together, would remove significant financing burdens from small, growing companies.

SEC Regulation D (Ban on General Solicitation)

Another potential avenue for capital formation in the biotech industry is SEC Regulation D. Under Rule 506 of Regulation D, companies can conduct offerings to accredited investors without complying with stringent SEC registration standards. This exemption allows companies to access accredited investors (who do not need

as much SEC protection) without burdensome disclosure requirements. However, the upside of this fundraising avenue is hindered by the ban on general solicitation in Rule 506. Companies are limited in their investor base by this Rule, meaning that a vast pool of investors remains untapped. If the ban on general solicitation were lifted, growing biotech companies would be able to access funds from the entire range of wealthy SEC accredited investors without undergoing the full SEC registration process.

BIO supports S. 1831 and H.R. 2940, the Access to Capital for Job Creators Act, which would require the SEC to revise Regulation D to permit general solicitation in offerings under Rule 506. If enacted, this legislation would enhance fundraising options for growing biotech companies searching for innovative cures and treatments.

Sarbanes-Oxley Section 404(b) Exemption

As you know, the Sarbanes-Oxley Act was passed in 2002 with the intent of protecting public investors from corporate fraud. At the time, President Bush praised it as a collection of "the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt." While we can all agree that investors benefit from greater transparency, some of the regulations found in SOX, namely Section 404(b), are unnecessarily burdensome on smaller companies, and often involve onerous compliance with little to no benefit to investors or the general public. In fact, many biotech companies facing their first few years on the public market are forced to divert funds from scientific research and development to the stringent Section 404(b) auditing requirements. The opportunity cost of this compliance can prove damaging, resulting in already limited resources being driven away from a company's search for cures and treatments.

The biotechnology sector is especially disadvantaged by the compliance burden of Section 404(b) due to the unique nature of our industry. The long, capital-intensive development period intrinsic to biotechnology often causes companies to have a relatively high market capitalization (caused by multiple rounds of venture financing prior to going public) but little to no revenue. All public companies with market caps greater than $75 million are forced to comply with Section 404(b), even though most biotech companies in a cash-strapped financial position can ill afford to pay for expensive external attestation of internal financial controls.

The main problem that these regulations cause for emerging public biotechnology companies is the need to divert resources away from innovation development to compliance for Section 404(b). The compliance costs are fixed and ongoing, and have a severe impact on the long-term investing of microcap and small cap companies at the forefront of developing new treatments for severe diseases. These small companies are the most affected by SOX at a time when they often have little or no product revenue to devote to compliance costs and must, as a result, shift funds from core research functions. This can lead to research programs being shelved or slowed as compliance takes precedence.

Further, the true value of biotech companies is found in scientific milestones and clinical trial advancement toward FDA approvals rather than financial disclosures of losses incurred during protracted development terms. Investors often make decisions based on these development milestones rather than the financial statements mandated by Section 404(b). Thus, the financial statements required do not provide much insight for potential investors, meaning that the high costs of compliance far outweigh its benefits.

Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act is an important acknowledgment by Congress that Section 404(b) of Sarbanes-Oxley is not an appropriate requirement for many small reporting companies. Dodd-Frank sets a permanent exemption from Section 404(b) for companies with a public float below $75 million. This provision is particularly important because it provides consistency to companies who now have a clear understanding as to whether or not they are exempt. However, it is too narrow in practicality and must be raised. Because of the business model of innovative industries like biotechnology, companies generally have very low revenues compared to their market capitalizations. For example, it is not uncommon for a newly public biotech company to have a market capitalization in excess of $600 million but have product revenues of $1 million or less. Such a company would be required to fully comply with Section 404(b) despite its lack of revenue with which to pay for compliance.

In 2006, the SEC Small Business Advisory Board recommended that the permanent exemption be extended to companies with public floats of less than $700 million to better fit the business model of industries like biotechnology. The Advisory Board's proposed ceiling would allow small innovative companies to focus on speeding cures and treatments to patients rather than SOX compliance.

The Advisory Board also realized that public float alone does not fully portray the complexity and risk associated with a reporting company, and suggested a revenue test to paint a fuller picture. Revenue should be a critical consideration when determining the appropriateness of Section 404(b) compliance, along with public float. The addition of a revenue test would better serve the congressional intent behind Sarbanes-Oxley by reflecting the truly small nature of companies with little or no product revenue. Public companies with a public float below $700 million and with product revenue below $100 million should be permanently exempt from Section 404(b), allowing them to focus their resources on critical research and development.

BIO strongly supports Congressman Fincher's efforts to raise the public float exemption to a more practical level. H.R. 3213, the Small Company Job Growth and Regulatory Relief Act, would provide companies with a public float of $350 million or less an exemption from Section 404(b). In conjunction with raising the public float exemption, BIO supports the use of a revenue test that exempts companies with product revenues below $100 million.

Additionally, BIO supports the concept of an IPO "on ramp," particularly as it provides relief from 404(b) requirements for newly public companies. BIO looks forward to reviewing upcoming legislation that addresses this issue.

The U.S. biotechnology industry remains committed to developing a healthier American economy, creating high-quality jobs in every State, and improving the lives of all Americans. Additionally, the medical breakthroughs happening in labs across the country could unlock the secrets to curing the devastating diseases that affect all of our families. There are many pitfalls and obstacles endemic to this effort, including scientific uncertainty and the high costs of conducting research. Congress has the opportunity to support and inspire biotechnology breakthroughs by unburdening startup companies and allowing innovators and entrepreneurs to continue working toward delivering the next generation of medical breakthroughs—and, one day, cures—to patients who need them.

Executive Summary

- The Biotechnology Industry Organization (BIO) represents more than 1,100 innovative biotechnology companies, along with academic institutions, State biotechnology centers, and related organizations in all 50 States.
- BIO supports S. 1544 and H.R. 1070, the Small Company Capital Formation Act. This would increase the eligibility threshold of SEC Regulation A from $5 million to $50 million while maintaining the same disclosure requirements.
- BIO supports S. 1824 and H.R. 2167, the Private Company Flexibility and Growth Act, which would raise the reporting trigger under the Securities Exchange Act of 1934 by increasing the shareholder limit and exempting employees from the count.
- BIO supports S. 1831 and H.R. 2940, the Access to Capital for Job Creators Act, which would require the SEC to revise Regulation D to permit general solicitation of accredited investors in private offerings under Rule 506.
- BIO supports legislation to relieve small companies from the unnecessary burden and expense of conducting an audit under Section 404(b) of Sarbanes-Oxley (SOX). H.R. 3213, the Small Company Job Growth and Regulatory Relief Act, would provide companies with a public float of $350 million or less an exemption from Section 404(b). BIO supports the addition of a revenue test with regard to the exemption from Section 404(b).

STATEMENT SUBMITTED BY THE COMPUTING TECHNOLOGY INDUSTRY ASSOCIATION

Introduction

Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, on behalf of the Computing Technology Industry Association (CompTIA) we appreciate the opportunity to submit testimony for the record. We wish to thank Chairman Johnson and Members of this Committee for holding this hearing on spurring job growth through capital formation. The topic of this hearing is critical. The majority of American job growth and innovation comes from small companies. In order to fuel economic expansion, we must assure that entrepreneurs and small businesses have the requisite capital to grow, innovate, and create jobs.

About CompTIA

The Computing Technology Industry Association (CompTIA) is a nonprofit trade association representing the $3 trillion global information technology (IT) industry.

CompTIA membership includes over 2,000 members and 1,000 business partners. Our members are at the forefront of innovation and provide a critical backbone that supports broader commerce and job creation. These members include computer hardware manufacturers, software developers, technology distributors, and IT specialists that help organizations integrate and use technology products and services. CompTIA is dedicated to serving its membership by advancing industry innovation and growth through its educational programs, market research, networking events, professional certifications, and public advocacy.

Background

Small businesses are the backbone of the American economy. There are approximately 30 million small businesses in the United States, which represent over 99 percent of all employer firms and employ over half of all private sector employees. Many participants in the IT industry are independent small businesses that provide a variety of functions for customers they serve. A sizeable portion of anticipated work force growth will emanate from start-up and small- and medium-sized (SMB) information technology firms. The SMB sector of the IT industry accounts for about 40 percent of industry jobs, or more than 2 million workers, and 163,000 employer businesses that maintain a payroll. The tough economic climate of the last few years has placed severe strains on many of these small businesses, with little relief in site. One of the most critical concerns has been the lack of access to capital. Whether seeking equity or debt financing, small businesses have significant difficulty gaining access to capital, which stunts their growth potential.

The Issue

For some time, CompTIA has been calling on Congress and the Obama administration to advance technology progress and job creation by providing small businesses and entrepreneurs greater access to growth capital. We believe that the Government can play a valuable role in paving the way for access to capital for small IT firms, which have a unique capacity to create jobs, produce commercial and technological innovations, and spur long-term economic growth. Better access to capital would allow these firms to develop new products, expand distribution channels, open new export markets, secure new customers, and fortify infrastructure. In this regard, CompTIA has called for direct-lending opportunities for small, growth-oriented technology firms. This need has been especially highlighted in view of the shortcomings of the Small Business Lending Fund legislation, which provides indirect assistance (with significant obstacles) to small businesses.

While we continue to support efforts to increase loans to growth-oriented small businesses, there are additional measures that should be taken to increase access to debt and equity capital. However, because of strict, complicated, and costly equity investment regulations and requirements, most small businesses have been effectively cut off from raising equity investments for their businesses. However, we believe that modest steps can and must be taken that will benefit small businesses in dire need of equity capital and also assure necessary safeguards for investors. This can be a win-win situation for investors, small businesses, unemployed citizens, and our national economy.

Crowdfunding

We have examined two proposals dealing with crowdfunding: H.R. 2930, "Entrepreneur Access to Capital Act," which passed the House by a wide margin on November 3, 2011, and is now awaiting action in the Senate; and S. 1791, "Democratizing Access to Capital Act of 2011," as introduced by Senator Brown on November 2, 2011. This Senate bill is currently under the jurisdiction of this Committee awaiting further action.

First, let us say that our membership is broadly supportive of efforts to enact simplified crowdfunding procedures. We view this as one avenue of revitalizing small business investment, which is needed to grow our economy and create jobs. With that said, we have analyzed both pieces of legislation and will summarize our specific recommendations.

In general, the House-passed legislation allows for a higher individual level of investment but contains additional compliance burdens for small businesses. CompTIA is concerned that the regulatory requirements in H.R. 2930 will add undue complexity and cost to the very reasons crowdfunding legislation was explored and introduced in the first place. The Senate bill eases regulatory burdens on small businesses but lowers the individual level of investment. Both bills would allow up to $1 million to be raised in a 12-month period; the House bill would allow up to $2 million if audited financial statements are provided to the investors. CompTIA supports inclusion of the optional $2 million limitation provided by the

House version. We believe that businesses should be allowed the higher limitation when audited financials are provided.

Further, CompTIA supports the higher individual investment limitation of $10,000, limited to 10 percent of income as provided under the House version. We understand that the Senate version seeks to protect investors by limiting exposure to a maximum of $1,000; however, $1,000 is simply too low, especially in situations where the company provides additional documentation, such as audited financial statements. Also, in many situations, investors will actually be other small businesses that are quite familiar with the issuer, as opposed to uninformed individuals. We do understand the need for safeguards to protect unwitting investors. However, we need to balance this with the benefits to be gained by legitimate offerings and the resultant value to our economy as a whole; neither can or should be absolute.

Generally, we support the requirements detailed under the Senate bill for issuers who do not use an intermediary in the offering. Under that legislation, issuers would be required to:

- Disclose to investors all rights of investors, including complete information about the risks, obligations, benefits, history, and costs of offering; and
- File such notice with the Commission as the Commission shall prescribe.

While we understand the intent of the detailed provisions contained in the House version is to protect investors, the many requirements placed on issuers would likely mire down the process and increase the cost of the offering, which is contrary to the goal of this legislation: Streamline the offering process for small businesses in order to increase equity investment. The basic question is how much should be required of the issuer in order to both protect the investor and maximize the issuer's ability to raise equity investment. We believe that rather than detailing each specific step, the safeguards provided in the Senate version requiring full disclosure and SEC notice reporting is a reasonable balance.

Finally, we commend the inclusion of State preemption in this legislation. Both bills would provide a level playing field for investors and issuers to come together across State lines under a common set of rules. Businesses are continually burdened with compliance requirement from the multiplicity of Federal, State, and local jurisdictions. A single set of rules that would apply nationally is critical to the success of crowdfunding legislation.

Other Proposed Access to Capital Reforms

Increase Exemption for Small Company Public Offerings. CompTIA supports legislation that would amend Regulation A of the SEC rules as it pertains to filing compliance. In short, H.R. 1070/S. 1544, the "Small Company Capital Formation Act of 2011," would reduce the filing and compliance burdens for certain small businesses that seek to raise capital through a public offering of stock. Simply put, this bipartisan legislation would increase the current $5 million limitation up to $50 million. This move is simply an updating of the antiquated $5 million limitation. As we have stated before, our economy clearly needs additional equity investment. Increasing the Regulation A exemption is an obvious adjustment that should be made immediately.

General Internet Solicitation in Public Offerings. There also have been discussions concerning a possible amendment of Regulation D of the SEC rules so that the Internet could be used to solicit public offerings. In today's economy, both investors and businesses survive and prosper with Internet applications and transactions. Clearly, the Internet offers issuers the ability to broaden their visibility and access to investors. With proper safeguards, it is no longer rational to bar issuers from employing the Internet in developing and promoting their equity offerings. The time has come for our securities laws to recognize that the Internet is here to stay and that it can actually be used to by issuers and investors alike to increase opportunities for equity investment in our economy.

Conclusion

America is clinging to its spot as the world leader in technology innovation. Unless we move to improve the ability of small businesses and entrepreneurs to access capital, our current economic climate will continue to stagnate. Congress can take modest, fiscally responsible steps to provide a better climate to improve access to capital for our small businesses. Nowhere is this more important than the fiercely competitive global IT industry. Clearly, increasing the ability of small businesses to raise equity capital is needed and will fuel job growth and our recovering economy.

So, in conclusion, we urge Congress to (1) increase the ability of our small businesses to raise equity capital through crowdfunding; (2) increase the small issuer

exemption; and (3) allow companies to use the Internet, the linchpin of our economic structure. These steps will certainly contribute to our economic recovery.

STATEMENT SUBMITTED BY BARBARA ROPER, DIRECTOR OF INVESTOR PROTECTION, CONSUMER FEDERATION OF AMERICA

As Chairman Johnson so aptly noted in his opening statement at this hearing, "Our Nation is facing an unemployment crisis. Nearly 14 million Americans are unable to find a job, and over 5 million have been unemployed for 6 months or longer." These Americans deserve serious proposals to put the Nation back to work, not poorly thought out legislative experiments that are at least as likely to increase the cost of capital for American companies as they are to promote sustainable job growth. Unfortunately, most of the proposals under consideration in this hearing fall into the latter category; even the best of the proposals are unlikely to result in meaningful job creation.

The bulk of the small company "capital formation" proposals are founded on a series of false premises. For example:

- Advocates of these proposals routinely highlight the fact that small companies disproportionately create jobs. But they conveniently overlook the fact that small companies also disproportionately destroy jobs. Proposals that indiscriminately encourage small company capital formation, without regard to the company in question's ability to grow and prosper, risk diverting capital from more sustainable enterprises, with a net negative effect on overall job growth.
- Advocates frequently highlight the fact that roughly 92 percent of job growth occurs after a company goes public. And yet they propose to dismantle precisely those characteristics of the public markets that make them such successful venues for capital formation—the ready availability of reliable information on which to make investment decisions, the existence of a liquid secondary market for shares, and robust protections against practices that advantage insiders at the expense of other shareowners, to name just a few.
- In crafting their proposals, advocates tend to focus exclusively on the compliance costs associated with becoming a registered public company and ignore the substantial benefits that flow from the accompanying regulations. It is not a coincidence that American public companies have enjoyed the lowest cost of capital in the world. They do so precisely because the risk premium imposed for investing in transparent, well regulated markets is lower. If an increase in fraud or even non- fraud-related investor losses results from proposals to diminish transparency and weaken investor protections, investors can be expected to demand an increase in the risk premium that at least equals and may well exceed any reduction in compliance costs, negating any job promoting benefits.
- Finally, advocates of these proposals have chosen to blame recent investor protection regulations rather than acknowledge the major changes in the market that have made small company IPOs less attractive than they were in the early years of the 1990s. But the institutionalization of the market that has occurred since that time has fundamentally changed the options for emerging companies seeking to raise capital, making a public offering (or at least an early stage public offering) less necessary. At the same time, the economics of the brokerage industry have changed radically—as a result of such factors as decimalization, electronic trading, and the emergence of alternative trading venues—making it unlikely that the extensive support that once existed for smaller IPOs can be recreated in today's markets.

In basing their proposals on false assumptions, supporters of these measures don't just incur the risk that their legislative proposals will be ineffective in promoting job growth. A side-effect of the increased risk to investors and reduced transparency is all too likely to be an increase in the cost of capital for American companies, particularly the smaller companies these proposals are intended to benefit, with a corresponding negative effect on capital formation and job growth. A further risk is that advocates of this deregulatory agenda will take any such failure to promote job growth not as evidence that their basic premise was misguided, but rather as an invitation to a further round of regulatory weakening, with the predictable result that fraud and investor losses will rise and that the cost of capital will rise along with them.

While most share a common set of largely false assumptions, the specific proposals under consideration in this hearing vary greatly in their approach and in the degree of risk they pose to investors and to market integrity.

Regulation A Revisions (S. 1544, "The Small Company Capital Formation Act of 2011")

While we do not support this bill in its current form, we do recognize that it is among the more thoughtful of the capital formation legislative proposals under consideration. In particular, its sponsors deserve credit for recognizing that there are benefits to providing investor protections along with the expanded Regulation A exemption, in the form of up-front disclosure, periodic reporting, audited financial statements, Securities and Exchange Commission (SEC) oversight, and a negligence-based litigation remedy. We are concerned, however, that the bill imposes no cumulative limit on use of the Regulation A exemption in multiple years and gives the SEC unlimited authority to increase the ceiling for Regulation A offerings. The latter is of particular concern because, in our view, the bill is unlikely to result in a dramatic increase in use of the exemption given the availability of more attractive options for raising capital either under Regulation D or from venture capital firms. If the bill fails to dramatically increase use of Regulation A, past experience has taught us that that is likely to be seen as a reason to raise the ceiling even further rather than to reexamine the assumptions underlying the approach. Absent a reckless expansion of this sort, however, and with the additional changes we have suggested, we believe the bill is relatively unlikely to do any serious harm and could possibly offer an attractive option for some small companies.

Crowdfunding (S. 1791, "Democratizing Access to Capital Act of 2011," and S. 1970, "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011")

The purpose of these bills is to create an Internet-based mechanism to allow start-up companies to raise relatively small amounts of seed money (up to $1 million in a 12-month period) from a dispersed group of small investors. The companies that take advantage of this option are likely to be those who are either not yet ready or have failed to attract backing from other sources, such as angel investors or venture capital firms. As a result, the start-up companies that rely on crowdfunding are likely to be among the riskiest, most speculative investments an investor could make.

For these reasons, we would expect to see very high losses for crowdfunding investors, even if appropriate steps are taken to ensure that crowdfunding sites do not become Mecca for fraud. In the 1980s, for example, it was estimated that investors had a 7 in 10 chance of losing some or all of their money in penny stocks simply because of the highly speculative nature of these investments. This risk of losses in penny stocks rose to 9 in 10 when the risk of fraud was included. Ultimately, Congress stepped in and adopted legislation to strengthen investor protections. But penny stocks were, if anything, less inherently speculative and better regulated than the kinds of companies that would take advantage of a crowdfunding options. Failing to learn the lessons of the past, the various crowdfunding bills that have been proposed would permit these highly speculative companies, and the con artists who would inevitably be attracted to the market, to hype their companies on the Internet and raise money from an unlimited number of investors with, under all the various bills except S. 1970, minimal if any regulatory oversight.

We appreciate the steps that Senate sponsors have taken to redress the most serious flaws in the House bill. Even S. 1791, while it falls well short of what is needed to prevent crowdfunding from becoming a haven for fraud, offers significant improvements over its House companion. In particular, it reduces the ceiling on individual investments from $10,000 per offering to a far more appropriate $1,000; it requires, rather than simply permits, use of an intermediary; and it subjects those intermediaries to a more robust set of regulatory requirements. While this is a step in the right direction, only S. 1970 includes a set of investor protections commensurate with the risks in crowdfunding. Among the most important of these are:

- the individual aggregate cap, which would help to ensure, in a way neither of the other bills does, that no individual could lose everything betting on these speculative investments;
- its requirement that crowdfunding intermediaries be registered with the SEC either as a broker-dealer or as a "funding portal" and subject to inspection and appropriate regulatory oversight;
- its more robust requirements with regard to the duties of the intermediary, which include a duty to monitor and enforce the aggregate individual investment limit, limits on conflicts of interest, and SEC authority to prescribe measures to reduce the risk of fraud;
- its prohibition on active solicitation by any crowdfunding site that is not registered as a broker-dealer; and

- its preservation of State authority.

We frankly question the wisdom on the crowdfunding proposals as a general matter. No one has yet explained to us why it is good public policy to allow even the most unsophisticated individuals to put substantial funds at risk investing in the most speculative of companies. S. 1970 at least offers some assurance that this effort would not simply recreate the boiler rooms of an earlier era in a riskier high-tech form. Without that assurance, there is every reason to believe crowdfunding will become a haven for fraud, where unsophisticated investors are hoodwinked out of their limited savings, and no new jobs are produced. Even with the necessary protections incorporated in S. 1970, we see very little reason to believe this will contribute in any meaningful fashion to overall job growth. As with penny stocks in the 1980s, the money lost is likely to greatly exceed the money that is successfully invested in sustainable enterprises, with no appreciable benefits in terms of job growth and significant damage to investor confidence in the integrity of our capital markets.

Shareholder of Record Requirements (S. 1824, "Private Company Flexibility and Growth Act")

This bill makes it easier for even very large companies to avoid providing the periodic disclosures on which transparent markets depend. It does this by simultaneously raising the limit on the number of shareholders of record who can hold a stock without triggering reporting requirements from 500 to 2,000 and exempting employees who hold company stock from the count. In addition, it would allow banks and bank holding companies to "go dark" if the number of shareholders of record dropped below 1,200. Moreover, it does all this without addressing the outdated and easily manipulated reliance on "shareholders of record" in making this determination. While we question the benefits of a proposal that is designed to reduce market transparency and reduce the incentives companies have to go public, the very least Congress should do if it feels compelled to adopt such a policy is to use a measure that is less subject to manipulation and less likely to permit even very large companies with large numbers of investors to evade basic reporting requirements.

IPO On-Ramp (S. 1933, "Reopening American Capital Markets to Emerging Growth Companies Act of 2011")

In some ways, this is the most cynical of the "capital formation" bills, because it offers the false promise that delaying compliance with a few investor protection and corporate governance requirements for a new class of "emerging growth" companies can magically restore the more IPO-friendly conditions that prevailed in the markets in the early 1990s and encourage more companies to go public. (Does anyone seriously believe, for example, that the requirement that public companies have a "say on pay" vote every 3 years is a serious impediment to capital formation?) Moreover, the bill extends its "on-ramp" even to very large companies that could easily afford the cost of compliance. And it attacks, not just existing investor protections, but the independent accounting and audit standard-setting processes.

As we discussed above, the real causes of the drop-off in IPOs can be traced to such factors as the institutionalization of the capital markets, changes that made Rule 144A offerings more attractive to small companies and institutional investors alike, and changes to the economics of the brokerage industry that made these firms less willing and able to offer extensive analyst coverage to or to otherwise support small company IPOs. Since it doesn't address these issues in any meaningful way, there is no reason to believe it will measurably change the considerations companies make when deciding to go public. On the other hand, it will measurably reduce investor protections adopted in the wake of episodes of widespread and very damaging fraud.

The bill's "on-ramp," which gives companies that go public 5 years to come into compliance with a number of the requirements of being a public company, perpetuates a dangerous trend that has emerged in recent years of enabling companies to go public before they are prepared to comply with the basic standards that go with raising money from average, unsophisticated investors. Indeed, this bill validates a prediction we made when it was first suggested that small companies be given a special exemption from SOX 404—that once policy makers started down the road of creating small-company carve-outs from the requirements for public companies, there'd be no end to their appetite for new and more expansive small company exemptions. As this bill makes clear, there need be no evidence that the carve-outs are necessary or justified or would have a significant impact on capital formation. The ultimate and inevitable conclusion of this approach is the creation of a small

company ghetto in the capital markets that investors will learn to shun because of the risks they face there.

It is particularly troubling that this bill continues to scapegoat SOX 404(b) for a drop-off in small company IPOs that cannot in good conscience be laid at its door. If SOX 404(b) were a determining factor, we would have expected to see a further drop-off in IPOs once the requirement was implemented. But charts showing U.S. IPO statistics pre- and post-SOX clearly show that IPOs were rebounding before the 2008 financial crisis disrupted the market. By the same token, if SOX 404(b) were a significant factor affecting small company IPOs, we would have expected to see a significant up-tick in such IPOs once the small company exemption was made permanent more than a year ago. But no such surge has occurred. In short, there is simply no evidence that SOX 404(b) significantly inhibits IPOs, or that allowing companies to delay implementation will lead to an increase in IPOs. [1]

The bill's backers seem to forget that SOX 404(b) was adopted in response to widespread fraud. We know, moreover, that the requirement to have effective internal controls over financial reporting, which had been on the books since the 1970s, was simply ignored until SOX added the requirement for an outside audit of those controls. Similarly, research since SOX was adopted has shown that management's attestation regarding internal controls is more likely to ignore existing weaknesses absent that independent evaluation. There is no reason to believe that "emerging growth" companies would be immune from these problems of lax compliance.

Indeed, by delaying implementation of SOX 404(b), the bill would give companies with up to $1 billion in gross revenues up to a full 5 years in which to raise money from the public without appropriate protections in place to prevent earnings management and other accounting irregularities. It is true, of course, that companies that engage in earnings management tend to hire, and even to over-hire, in the short term. [2] But they then shed those jobs—and, often, many others—very quickly when the fraud comes to light. In fact, research has shown that the public companies that had to restate their earnings in 2000 and 2001 subsequently lost between 250,000 and 600,000 jobs.

The sponsors of this bill ignore extensive evidence such evidence that argues against this approach. Research has shown, for example, that the cost of compliance has come down significantly in the 10 years since SOX was adopted, that compliance with 404(b) improves the quality of financial reporting, and that, as a result, 404-compliant companies enjoy a lower cost of capital than noncompliant companies. Ironically, the bill would perpetuate for all new companies one of the key factors contributing to the initial high cost of implementing SOX 404(b): the cost of retrofitting controls onto established system. Because it simultaneous exaggerates the benefits that would flow from delaying implementation of SOX 404 and ignores the potential costs, the legislation adopts an approach that is at least as likely to inhibit job growth as it is to spur it. Worse, experience tells us that, when this bill fails to deliver the promised up-surge in IPOs, its backers will be back with further proposals to spur growth by undermining investor and market protections.

Conclusion

One of the things that is discouraging about these bills is the degree to which they reflect our policy makers' apparent inability or unwillingness to learn from the past. The Internet bubble and bust, the analyst scandals, the accounting scandals, and the recent financial crisis all had a devastating impact on our markets. All seriously inhibited capital formation and job growth, with particularly severe and lingering effects in the case of the most recent financial crisis. And each in its own way was the direct result of fatal weaknesses in financial regulations designed to protect investors, promote transparency, and ensure the integrity and stability of our financial markets. By ignoring the lessons of those events, the majority of these so-called "capital formation" bills offer at best gimmicky solutions to a serious problem and at worst offer "solutions" that will actually make the problem worse. It is a cruel and cynical tactic to exploit the jobs crisis to ram through special-interest deregulatory proposals that, in the long run, could trigger even more financial bad news and even more lost jobs. The millions of out-of-work Americans who are victims of our last experiment with financial deregulation deserve better.

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[1] Some have suggested that SOX 404(b) is often cited by foreign companies that decide against listing in U.S. markets. But these companies are unlikely to acknowledge other factors, such as the limits that exist here on siphoning off IPO proceeds to enrich a few insiders and on affiliated transactions on terms that disadvantage general shareholders. SOX 404(b) is a convenient scapegoat for companies whose real goal is to avoid far more basic investor protections that come with a U.S. listing.

[2] Simi Kedia and Thomas Philippon, "The Economics of Fraudulent Accounting" (January 2005). AFA 2006 Boston Meetings Paper. Available at SSRN: *http://ssrn.com/abstract=687225.*

Consumer Federation of America (CFA) is a nonprofit association of approximately 280 national, State, and local proconsumer organizations. It was founded in 1968 to advance the consumer interest through research, advocacy, and education.