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and

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Before the

House Committee on Financial Services

Subcommittee on Capital Markets and Government Sponsored Enterprises

"*Legislation to Further Reduce Impediments to Capital Formation*"

October 23, 2013

Washington, DC

Introduction:

Good morning Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee, I'm Heath Abshure, Securities Commissioner for the State of Arkansas. Until earlier this month, I was also the President of the North American Securities Administrators Association, Inc. ("NASAA"),[1] the association of state and provincial securities regulators.

Prior to serving as NASAA president, I served as the chairman of both NASAA's Special Committee on Small Business Capital Formation, and NASAA's Corporation Finance Section. In addition, since 2011, I have served as an observer member of the SEC's Advisory Committee on Small and Emerging Companies, which has recently considered many of the same questions that will be examined at the hearing today.

I, personally, have a deep interest in issues related to small business finance and capital formation, and I am honored to testify for a second time before this Subcommittee about these issues.

Securities regulation is a complementary regime of both state and federal securities laws, and the states work closely together to uncover and prosecute securities law violators. 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, especially those who lack the expertise, experience, and resources to protect their own interests.

The securities administrators in your 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.[2]

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

In addition to serving as the "cops on the beat" and the first line of defense against fraud for "mom and pop" investors, state securities regulators serve as the primary

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (NASAA) was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] States are also the undisputed leaders in criminal prosecutions of securities violators. In 2012 alone, state securities regulators conducted nearly 6,000 investigations, leading to nearly 2,500 enforcement actions, including 339 criminal actions. Moreover, in 2012, 4,300 licenses of brokers and investment advisers were withdrawn, denied, revoked, suspended, or conditioned due to state action, up 28 percent from the previous year.

regulators of most small company securities offerings. As such, state securities regulators regularly work with and assist local businesses seeking capital to grow their companies.

The states are committed to fostering responsible capital formation which in turn strengthens investor confidence and leads to job growth. At the same time, and as I testified to the Subcommittee in 2011, capital formation will be impeded when investors are not adequately protected.

Advisory Committee on Small and Emerging Companies

For over two years, I have had the privilege of serving as NASAA's designated member of the SEC Advisory Committee on Small and Emerging Companies ("Advisory Committee").

The Advisory Committee was established on Oct. 4, 2011, for a term of two years, and reauthorized for a second term earlier this month. Since the Committee was established, it has provided recommendations to the Commission regarding rules, regulations, and policies related to emerging companies, capital raising through private placements and public securities offerings, and reporting requirements for small and emerging publicly traded companies.

Some of the policies enacted last year by the JOBS Act were based on recommendations of the Advisory Committee. In 2011, I testified before this Subcommittee and expressed concern about many of the policies in the JOBS Act, including legislation that directed the SEC to lift the ban on general solicitation in private securities offerings, and to implement rules to legalize "equity" crowdfunding.

I remain deeply concerned that some of the policies enacted under the JOBS Act, including in particular, the lifting of the ban on general solicitation in Regulation D, Rule 506 offerings, will be detrimental to investors and ultimately to the companies that rely on this method of capital formation.

The SEC is currently considering a number of proposed amendments to the general solicitation rule adopted in July pursuant to Section 201 of the JOBS Act. NASAA strongly supports these proposed amendments.[3] It will be essential that the Commission move swiftly to adopt many of these proposed amendments, especially the proposed requirement that "Form D" be filed prior to the first sale that occurs in any Regulation D offering that uses general solicitation.

[3] See NASAA Comments in Response to Release Nos. 33-9416, 34-69960, IC- 30595 (File No. S7-06-13), "Amendments to Regulation D, Form D and Rule 156 under the Securities Act." 27 September, 2013. Accessible at: http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Comment-Letter-re-Form-D.pdf

Overview of NASAA Perspective on Today's Legislation

Today, the Subcommittee is considering a number of new bills related to capital formation.[4] These include proposals to (i) streamline registration requirements of so-called "merger and acquisition brokers;" (ii) further ease reporting requirements applicable to "Emerging Growth Companies" or EGCs; (iii) and relax portfolio strictures, leverage limits, and other regulations for business development companies (BDCs). They also include common-sense proposals to reduce "red tape" that adds to the compliance costs of small and startup businesses, such as the SEC's requirement that certain filings be made using eXtensible Business Reporting Language (XBRL).[5]

NASAA's view regarding this new collection of bills is mixed. NASAA supports a number of these proposals; especially the proposed Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013 sponsored by Congressman Huizenga, but has concerns with other legislation pending before the Committee today. Most notably, NASAA is troubled by the proposal to further expand what are basically new, untested regulatory carve-outs for EGCs as well as proposals that would increase leverage and conflicts of interests in the BDC space. There are some bills before the Subcommittee on which NASAA does not have a strong stakeholder interest. For those bills, I will simply offer my own personal observations based on discussions I have had with others as part of my work on the Advisory Committee. Insofar as that latter category of bills does not pertain directly to state securities regulation, NASAA neither supports nor opposes their enactment.

Streamlining Registration for Mergers & Acquisitions Brokers

State securities administrators generally support the targeted, well-balanced provisions of H.R. 2274, the Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013, H.R. 2274. This legislation would establish a simplified and streamlined registration process for broker-dealers engaged solely in the business of effecting the transfer or sale of privately held companies (i.e., "M&A brokers"). NASAA is optimistic that this legislation will encourage registration and regulatory compliance by M&A brokers.

The registration process is an integral part of an overall regulatory regime at the state and federal level that is designed to promote responsible business practices among broker-dealers and to help protect investors. Generally, broker-dealers engage in the buying and selling of securities either for their own account or for the accounts of others. Broker-dealers may also engage in other businesses such as underwriting securities

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[4] At least one of the discussion draft bills before the Subcommittee is modeled on a recommendation of the Advisory Committee. See U.S. Securities and Exchange Commission. Advisory Committee on Small and Emerging Companies. Recommendations Regarding Trading Spreads for Smaller Exchange-Listed Companies. February 1, 2013. Accessible at http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-032113-spread-tick-size.pdf

[5] While NASAA is supportive of reasonable statutory or regulatory forbearance for compliance with XBRL requirements for small businesses, as explained elsewhere in this testimony, we consider that the $1 billion annual revenue threshold contemplated by the discussion draft is far too high.

offerings and the making of markets for new and emerging companies. The current registration process is well suited to the vast majority of these broker-dealers. However, these registration requirements may not be as well suited to a limited number of broker-dealers engaged exclusively in the business of mergers and acquisitions (M&A Firms).

M&A Firms, as defined in H.R. 2274, would be limited to those firms engaged solely in the business of affecting the transfer of ownership of certain eligible privately held companies. As a result, the traditional registration process for broker-dealers is not particularly well suited for the M&A Firms. Furthermore, individuals who work for these firms and earn commission-based compensation in M&A deals have the additional burden of affiliating with a registered broker-dealer firm in order to obtain registration. The expense and compliance with the registration requirements has led many M&A firms, particularly those handling small M&A deals where firms typically pass on the cost of regulatory compliance to their clients, to forego registration and compliance requirements altogether. There is no public record of these unregistered firms or individuals, or the fees they earn for their services. There is no regulatory body (whether a government regulator or a self-regulatory organization) confirming that clients receive appropriate disclosures such as conflicts of interest and a list of employees and affiliates.

Investor protection is best served when regulatory necessity and transparency is balanced sensibly with the practicalities inherent in any business model. In the case of M&A brokers, H.R. 2274 strikes an appropriate balance. The bill reduces the standard regulatory requirements applicable to traditional broker-dealer firms and provides M&A brokers of privately held companies (as defined therein) with a simplified registration regime that provides sufficient oversight to these firms without diminishing the authority of state or federal regulators.

The M&A industry has worked with NASAA in developing the proposal that is contained in H.R. 2274. We welcome its introduction and look forward to supporting the legislation in the 113th Congress.

Notwithstanding our general support for H.R. 2274, NASAA does object to one provision – (a)(13)(G)(iii) State Law Preemption – that references Section 15(i)(1) of the Securities Exchange Act of 1934 (Exchange Act). Section 15(i)(1) governs capital, margin, books and records, bonding and reporting requirements of the Exchange Act, and the limitations on any conflicting or superfluous requirements under state law. NASAA posits that adding Section (a)(13)(G)(iii) in H.R. 2774 creates an unnecessary and confusing addition to an otherwise seamless bill governing M&A brokers. Section 13(G)(iii) titled "State Law Preemption" provides as follows:

> Subsection (i)(1) shall govern the relationship between the requirements applicable to M&A brokers under this Act and the requirements applicable to M&A brokers under the law of a State or a political subdivision of a State. Except as provided in such subsection, this paragraph shall not preempt the law of a State or a political subdivision of a State applicable to M&A brokers.

This "preemption" paragraph in fact refers to a limited preemption already in the Exchange Act addressing books and records, and reporting requirements. NASAA has worked with the M&A industry to obtain their support for withdrawing this language, and we ask that Representative Huizenga and the Committee consider removing this redundant, and arguably confusing, paragraph from the bill.

Business Development Companies

The Subcommittee is presently considering several bills that contemplate relaxation of the portfolio strictures and other limitations on the ability of Business Development Companies (BDCs) to invest in financial companies.

Three bills pending before the Subcommittee – H.R. 31, H.R. 1800, and H.R. 1973 – would repeal the provisions of the Investment Company Act of 1940 (ICA) that limit the ability of a BDC to invest in investment advisers. Two of these bills, H.R. 31 and H.R. 1800, would additionally ease the leverage limits for BDCs established by the ICA, allowing such firms to maintain a greater ratio of debt to asset valuation on their balance sheets, and would direct the SEC to revise its forms and filing instructions for "shelf registrations" to permit BDCs to incorporate by reference in their shelf registrations subsequent financial reports. The most radical change contemplated by any of the bills before the Subcommittee occurs under H.R. 1973, which would redefine financial services companies as "eligible portfolio companies," thereby obviating all existing limitations on the ability of BDCs to invest in financial companies[6].

Before I address these changes, it may be helpful for me to provide the Subcommittee with some background information on BDCs in general. BDCs are regulated, closed-end investment firms that invest in small, developing, or financially troubled companies. As entities that combine the capital of many investors to finance a portfolio of operating businesses, BDCs are governed by the Investment Company Act of 1940 (ICA). BDCs are unique, however, in that they enjoy a number of important exemptions from the ICA that have allowed them in recent years to step into the role that regional commercial banks largely vacated during the financial crisis—lending to companies that may not otherwise get financing.

BDCs are attractive to many investors for three primary reasons. First, investors are drawn to the very high rate return that BDCs offer – sometime in excess of eight percent.[7] Second, under normal market conditions, BDCs also provide investors with liquidity comparable to that of other publicly traded investments. In contrast, investors in open-end investment companies or traditional mutual funds may only sell and buy shares directly to and from the fund itself. The third reason many investors invest in BDCs is

[6] As contemplated by H.R. 1973, financial companies would include not only firms that deal in securities, but also depository institutions like banks and credit unions, insurance companies, credit card companies, and a host of other entities that primarily derive their revenue from financial transactions and the sale of financial products.

[7] Notably, BDCs are also required to distribute at least 90% of their taxable earnings in the form of dividends.

simply access because investors do not need to meet the higher income, net worth or sophistication criteria that are imposed on private equity investments.

By virtue of their unique treatment under the ICA, BDCs enjoy a number of regulatory advantages relative to traditional investment funds. BDCs are permitted to use more leverage than a traditional mutual fund, up to and including a 1-to-1 debt-to-equity ratio. BDCs can also engage in affiliate transactions with portfolio companies. BDC managers also have access to "permanent capital" that is not subject to shareholder redemption or the requirement that capital be distributed to investors as returns on investments are realized. Moreover, managers of BDCs may immediately begin earning management fees after the BDCs have gone public and, unlike other registered funds, charge performance fees.

In exchange for considerable regulatory latitude, BDCs adhere to certain portfolio strictures not applicable to other registered funds. Most prominently, BDCs have an asset coverage ratio of 200%, at least 70% of which must be in "eligible" investments.[8] In addition, the ICA prohibits a BDC from acquiring more than 5% of any class of equity securities or investing more than 5% of its assets in any company that derives more than 15% of its revenues from securities-related activities, including acting as a registered investment adviser. It is this part of the regulatory bargain that today's BDC bills attempt to renegotiate.

State securities regulators question the rationale for further relaxing the leverage limits applicable to BDCs, as contemplated by H.R. 31 and H.R. 1800.

As I just mentioned, the current asset coverage ratio applicable to BDCs is 200%. This means that every dollar of a BDC's debt must be "covered" by two dollars of BDC assets. In other words, it effectively limits a BDC's leverage ratio to 50% of assets, which is meant to make BDCs safer and more stable for investors. Excessive leverage by some of our largest financial institutions, as you might recall, was at least part of the problem we faced as part of the most recent financial crisis and many other crises before it. Moreover, the BDC asset coverage ratio has already been adjusted to balance sponsor and investor need, reduced from the initial threshold of 300% for closed-end funds, down to 200%.[9] While BDCs may desire the higher fees they could generate from their increased leverage, that desire is not a compelling justification for increasing leverage and risk to investors, especially unsophisticated retail investors. In the absence of such a justification, NASAA is disinclined to support the measure.

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[8] Eligible investments include: (1) privately issued securities purchased from "eligible portfolio companies," (2) securities of eligible portfolio companies that are controlled by a BDC and of which an affiliated person of the BDC is a director, (3) privately issued securities of companies subject to a bankruptcy proceeding, or otherwise unable to meet their obligations, (4) cash, government securities or high quality debt securities maturing in less than one (5) facilities maintained to conduct the business of the BDC, such as office furniture and equipment, interests in real estate and leasehold improvements.

[9] Under the Investment Company Act of 1940 the asset coverage requirement for closed-end funds is 300% for debt securities and 200% for preferred stock. The Small Business Investment Incentive Act of 1980 reduced the asset coverage ratio for BDCs to 200% from the 300% applicable to non-BDC investment companies under sec. 18(a)(1)(A) of the ICA.

Another change contemplated by H.R. 31 and H.R.1800 that NASAA does not fully understand and, therefore, does not support is the proposal to allow BDCs to issue multiple classes of debt securities and senior equity securities. The effects of this provision on common shareholders, retail investors in every one of your districts, and many senior investors, could be quite harmful. Specifically, allowing BDCs to issue preferred stock is inviting them to dilute the value owned by holders of common stock. Moreover, by allowing preferred stock to count on the equity side of the ratio, the effect of the change would be to permit BDCs to issue greater amounts of debt, potentially placing the holders of common shares in a position where they could be wiped out in the event the BDC incurred losses. This would not serve BDC investors well.

State securities regulators have significant concerns about provisions in H.R. 31, H.R. 1800, and H.R. 1973 that would remove existing prohibitions on the ability of BDCs to invest in investment advisers.

Conflicts of Interest and Business Development Companies

While the foregoing changes are problematic, NASAA's primary concern with the BDC bills is the proposal that would allow BDC investment in IA firms. That proposal would create a significant conflict of interest. If an advisory firm were among a BDC's portfolio of companies, an incentive would exist for the investment adviser to recommend, or even push, their clients toward investments in the BDC or its other portfolio companies, even if such investments were not in the client's best interest.

Such conflicts could be even more troublesome in the context of an adviser's discretionary or "managed" accounts, where the adviser is delegated authority to make investment decisions on behalf of the client. As BDC directors also owe a fiduciary duty to their shareholders, if the proposed change were enacted, it would increase the likelihood that BDCs will acquire interests in advisory firms for the express purpose of accessing the advisory firm's pool of investible capital. This conflict could be exacerbated in the event that a BDC's portfolio company underperforms and the captive advisory firm is seen as a way to shore up the struggling company with additional capital.

No such conflicts of interest exist now, and NASAA urges Congress not to allow for such a conflict of interest to arise as it considers reforms to the BDCs portfolio strictures.

Transparency and Business Development Companies

Beyond the conflict of interest inherent in the repeal of restrictions on BDC investments in advisory firms, NASAA is concerned that such repeal would cause a significant loss of transparency.

BDCs that are registered with the states have limited transparency in a number of respects. State securities regulators usually see them in state registration as startups, or as businesses with a very limited history of operations. They are frequently "blind pool" offerings in which investors have little or no access to information regarding the investments the BDC will make. Disclosure documents describing eligible portfolio companies can be vague, broad, and limited. For example, a BDC might disclose that it primarily intends to invest in debt and equity securities of small to middle market private U.S. companies. Such vague disclosure as to the use of proceeds grants broad discretion to BDC managers while reducing transparency to investors.

Investors must place their reliance and trust in the management of the BDC to select appropriate companies for the BDC to lend to. Many BDCs have made a niche in lending to companies that have recently struggled with bank financing. Allowing investments in investment advisers adds an additional layer of opacity for BDC investors. NASAA believes BDC investors should continue to receive adequate disclosure about the income producing assets of the investment adviser.

Impact on Shareholders and Job Creation of Business Development Companies

Finally, NASAA cannot help but observe that competition from financial services firms will <u>not</u> benefit traditional BDC portfolio companies – i.e., small businesses.

BDCs were initially created for the purpose of providing capital to domestic small and medium-sized businesses that participate in the real economy. Since their creation, BDCs have enjoyed relaxed regulatory requirements to further this goal; this is the reason financial firms have traditionally been excluded as eligible portfolio companies. Under the proposed legislation, however, these small businesses will presumably face new and greater difficulty obtaining BDC financing because BDC's will reallocate some of their limited resources to investment advisers and other financial firms. Such an outcome may frustrate the Subcommittee's goal of spurring job growth.

Moreover, NASAA is not aware that investment advisory firms have any real need for BDC financing, especially as compared to the smaller real economy firms that BDCs were designed to benefit.

State securities regulators understand and support sensible modernization of regulations applicable to BDCs and other companies.

While most of the proposals set forth in the BDC bills have issues from a state and investor protection perspective, NASAA does support the proposal to extend the relaxed regulatory requirements available to Well Known Seasoned Issuers ("WKSI") and certain other large public filers to BDCs. BDCs operate similarly to large public companies in regard to communications with the public and the filing of forms with the Commission.

Under the amendments contemplated by H.R. 1800 and H.R. 31, BDCs would be eligible for WKSI status and would be eligible to file automatic shelf registrations on forms S-3 or N-2. Automatic shelf registrations are automatically effective upon filing and receive no SEC review. To be eligible, BDCs would be required to have a class of securities with at least $700 million in public float or have completed a public issuance of at least $1 billion. Some state-registered non-traded BDC offerings have already reached this threshold and would be eligible for automatic shelf registration with limited information and incorporation by reference.

NASAA did not oppose incorporation by reference for real estate investment trust (REIT) offerings a number of years ago, and NASAA similarly does not oppose amending the ICA to permit incorporation by reference for BDCs today.

In summary, NASAA considers that small and mid-size companies that produce goods and services in the real economy have a greater need for BDC loans, and are better positioned than financial companies to use the capital from these loans to create jobs and improve the economy. Repeal of the provisions that limit BDC investment in financial services companies, as contemplated by H.R. 1973, or even investment advisers only, as contemplated by all three of the bills, will, at best, serve to dilute the impact of BDC investment capital as a source of job creation. Such policies might also create incentives for BDCs to help financial services companies design their business strategies, with the main goal of aiding the financial services sector, not building small businesses in other sectors of the economy.

Further Reduction of Publicly Available Information about Emerging Growth Companies

NASAA is also concerned about discussion draft legislation that would further relax reporting requirements for so-called emerging growth companies (EGCs).

Under the proposed discussion draft, EGCs would benefit from a dramatic shortening of the window of time between the completion of a confidential filing with the SEC and the beginning of the "road show" marking its initial public offering (IPO). While NASAA recognizes that from the standpoint of the issuer, the shortening of the required waiting period from 21 days to 5 days may be beneficial, as it reduces the likelihood of external events impacting the offering, the 21 day period is already a relatively short window of time. Moreover, non-EGC companies seeking to go public do not even enjoy an opportunity for confidential review. Like many of the provisions in the discussion draft, this change raises questions about how far Congress is willing to extend favorable treatment to a particular class of companies, and who exactly stands to benefit from such changes.

In addition, whereas the JOBS Act authorized EGCs to submit registration documents to the SEC for review on a confidential basis prior to an IPO, the proposed legislation would permit EGCs to enjoy this same "confidential review" privilege for follow-on offerings of securities issued after the IPO. When Congress established the mechanism for EGCs to obtain confidential SEC review of registration documents under the JOBS Act, its expressed purpose was to encourage companies to go public. It is not clear why the privilege should now be extended to companies that, by definition, have already successfully completed an IPO.

Similarly, the bill requires that EGCs be permitted to file registration documents for confidential SEC review that "omit financial information for historical periods otherwise required by regulation." Time and again, accounting scandals have shaken public confidence in the markets and demonstrated the critical importance of complete and accurate financial reporting. Such an omission runs counter to the interests of investors, the public, or our capital markets.

The Securities Act of 1933 reflects the principle that "sunlight is the best disinfectant."[10] In fact, during the signing of the bill President Roosevelt emphasized that a well-functioning capitalist system must be built upon a foundation that requires the full disclosure of accurate information to investors:

> Events have made it abundantly clear that the merchandising of securities is really traffic in the economic and social welfare of our people. Such traffic demands the utmost good faith and fair dealing on the part of those engaged in it. If the country is to flourish, capital must be invested in enterprise. But those who seek to draw upon other people's money must be wholly candid regarding the facts on which the investor's judgment is asked.
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> To that end this Bill requires the publicity necessary for sound investment. It is, of course, no insurance against errors of judgment. That is the function of no Government. It does give assurance, however, that, within the limit of its powers, the Federal Government will insist upon knowledge of the facts on which alone judgment can be based.[11]

The ink is barely dry on the JOBS Act and we do not yet know what impact Title I will have on the number of IPOs. More importantly, we do not yet know whether it will affect investors' willingness to invest in the emerging growth companies that are so vital to our economy. Despite these uncertainties, the discussion draft would go even further than Title I by reducing the information that is available to investors and giving them less time to digest it.

NASAA respectfully urges the Subcommittee to reject further changes to Title I, at least until the full impact of Title I on investors and securities markets can be observed and evaluated. Until such time, the potential costs and benefits of further expanding Title I will be impossible to determine.

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[10] "[P]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants…. The potent force of publicity must…be utilized in many ways as a continuous remedial measure." Louis D. Brandeis, *Other People's Money* 62 (R. Abrams ed. 1967).
[11] President Franklin D. Roosevelt. "Statement on Signing the Securities Bill," 27 May, 1933, available at http://www.presidency.ucsb.edu/ws/?pid=14654

Tick Sizes and the Small Cap Liquidity Reform Act

Proposals to promote greater liquidity for EGCs or other thinly traded stocks by experimenting with changes to the ‘‘tick sizes,’’ or minimum increment for quoting shares, for certain smaller public companies, raise interesting policy questions. However, from a standpoint of public and market-regulatory policy, such proposals also raise a number of concerns.

The proposal that is before the Subcommittee today would direct the SEC to establish a pilot program that would increase the spread between bid and offer prices for EGCs, boosting profits for market-makers. The sponsors of the proposal evidently expect that the increased revenue realized by such market makers from the widened spreads will, in turn, support additional research or "coverage" of the stocks in question. Greater coverage of EGC stocks by analysts, the thinking goes, will in turn lead to more initial public offerings and greater liquidity for EGC shares following their initial offering.

NASAA appreciates that there is less analyst coverage of many smaller company stocks than their shareholders might like; however, we question whether changing the mechanics of the securities market in the hope of subsidizing artificial interest in and coverage of such securities is something Congress should pursue.

There can be little question but that broker-dealers and others who serve as market makers for EGC stocks have a financial incentive to support such a change. It is also understandable that EGCs, and their managers, perceive in such a program the prospect of increased research coverage of their securities, and by extension, greater liquidity.

However, it is far from clear how any of these changes will stand to benefit the investing public. Indeed, quite to the contrary: increasing the spread between bid and ask prices for shares of EGC securities will systemically strip value from the holders of the securities and reallocate it to broker-dealers and others who act as market makers in these securities.

Moreover, as a matter of basic economics, it is evident that by manufacturing additional, artificial transaction costs for the exchange of EGC securities, the proposed pilot program would have the effect of diminishing rather than increasing overall marketplace efficiency.

NASAA believes that, as general matter, Congress should exercise great caution anytime it considers a policy that would make securities or other markets more costly and <u>less efficient</u>.

There are many valid and important reasons why in some instances the government should undertake actions, consistent with the interests of the investing public, which may have the effect of decreasing marketplace efficiency – for example, to protect investors from fraud and abuse, to prevent excessive speculation, or to prevent market panic. In this instance, however, the proposed pilot program appears to offer little, if any, of these benefits to the investing public while increasing their transaction costs.

eXtensible Business Reporting Language (XBRL)

eXtensible Business Reporting Language (XBRL) is an international standard used for exchanging and reporting business information. XBRL makes use of "interactive data" to indentify trends and patterns that would not otherwise be recognizable or accessible.

XBRL allows for the automated processing of business information by computer software, cutting out laborious and costly processes of manual re-entry and comparison. This is highly useful for financial regulators such as the SEC, since the SEC's computers can recognize information filed in XBRL format, analyze it, store it, and ultimately compare it on an "apples to apples" basis with other filings to obtain an extremely precise and highly useful picture of market participants and market activities.[12] Interactive data also allows investors and others to pinpoint facts and figures within often lengthy disclosure documents.[13]

In early 2009, the SEC published three final rules requiring XBRL tagging of certain disclosure information for operating companies, mutual funds, and credit rating agencies. One of the bills before the Subcommittee today would effectively repeal this requirement for firms with total annual revenues of less than $1 billion. Under the bill, roughly three in every four public companies would be exempt from providing this meaningful information.

As a general matter, NASAA shares the view of other advocates for transparency, from the SEC's Investor Advisory Committee to the Chairman of the House Committee on Oversight and Government Reform, in supporting the use of XBRL and other filing protocols that maximize meaningful disclosure that benefits the investing public.[14] Accordingly, NASAA does not believe that Congress should, at this time, repeal the XBRL reporting requirement for all public companies with less than $1 billion in annual revenues.

[12] Federal Financial Institutions Examination Council. Report entitled: "Improved Business Process Through XBRL: A Use Case for Business Reporting" 31 January, 2006. Accessible at http://www.xbrl.org/Business/Regulators/FFIEC-White-Paper-31Jan06.pdf.
[13] Securities Exchange Commission. http://www.sec.gov/spotlight/xbrl/what-is-idata.shtml.
[14] Letter from House Oversight and Government Reform Committee Chairman Darrell E. Issa to SEC Chair Mary Jo White regarding SEC implementation and enforcement of the Interactive Data to Improve Financial Reporting Rule of 2009. 10 September, 2013. Accessible at http://oversight.house.gov/wp-content/uploads/2013/09/2013-09-10-DEI-to-White-re-Interactive-Data-Rule.pdf.

At the same time, state securities regulators are very sensitive to the compliance cost that XBRL may be placing on some truly small companies, and in the case of such companies, we would hope that Congress and the SEC would afford filers with a more limited exemption, or forbearance, to minimize any excessive cost or burden associated with this new filing protocol.

Other Ideas for Spurring Capital Formation Through Pro-Investor Reforms

NASAA shares the goal of Congress to improve the United States economy by spurring private investment in businesses. However, we are concerned that the Committee may be attempting to reach this goal through a strictly one-sided approach – namely, by eliminating regulations that appear to be burdensome to businesses who want to raise capital. We encourage the Committee to take a more balanced approach and to consider reforms that will restore investor confidence in the markets. What we need is smarter regulation, not merely deregulation.

A Gallup survey in June 2002 found that 67 percent of Americans owned a 401(k) or otherwise invested in individual stocks, bonds, or mutual funds. Earlier this year, that number was down to 54 percent.[15] If this Subcommittee wants to spur economic development through capital formation, it should focus on giving that missing 13 percent the confidence to re-enter the marketplace.

The reasons for investor nervousness seem obvious. Many Americans lost a big share of their retirement savings during the economic meltdown and now view the stock market as a "casino" that is rigged by insiders and high frequency traders. These investors also hear about computer errors and false news stories that cause flash crashes, and they understandably wonder whether the markets are sufficiently stable to invest their retirement savings.[16]

Of course, this is not the first time in our history that investors need their faith in the markets restored. The original Securities Act of 1933 was not meant to punish Wall Street for the stock market crash of 1929, but rather to lift the country out of the resulting depression by restoring investor confidence and spurring new capital formation. Felix Frankfurter, a principal drafter of the Securities Act, spoke of the strain on our markets at that time:

> The great and buoyant faith in capitalism, in the competitive system, is largely deflated, and . . . it is not only a question of whether the system is just, but whether it works. When you have a system which is questioned

[15] See http://www.gallup.com/poll/147206/stock-market-investments-lowest-1999.aspx.
[16] In the past several years, major market disruptions that have not been adequately explained, but which appear to be linked to electronic trading, include the May 6, 2010 "Flash Crash," the BATS IPO, and the Knight Capital "fat finger" incident.

> by the masses, that system cannot last unless it wins back the loyalty and allegiance of the doubters. . . .[17]

Today, investors need a similar boost of confidence in the securities markets. It is counterproductive to capital formation when Congress continually chips away at the protections that investors have come to expect, and Congress could help small businesses more effectively by looking for reforms that will make investors comfortable investing again. NASAA has not yet come to firm conclusions about reforms that would provide a cure to investor cynicism, but we are intrigued by a few ideas that seem worthy of further study by this Committee.

First, we believe that Congress should study the impact of high frequency trading and take steps to ameliorate any harm to retail investors. According to Charles Schwab, high frequency traders flood the market with orders to evaluate the market, then cancel 90 percent or more of the orders and retain only the advantageous trades.[18] To curb these abuses, some European governments have proposed transaction taxes on all orders that are placed in the markets, but Mr. Schwab has suggested a narrower approach that would probably be less controversial and more effective – a penalty on excessive cancellations.[19]

Another innovative effort to combat high frequency trading has been undertaken by ParFX and EBS, two international currency trading platforms. They use a randomized pause so that the first order placed in the system queue is not necessarily the first to be executed.[20] According to Larry Tabb, founder of the TABB Group, "In the equities market, it's going to be pretty tough for an exchange to introduce randomization because the regulations have been interpreted to be very time-price specific."[21] Therefore, Congress might consider amending the laws to allow this type of reform in the United States equities marketplace.

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[17] L. Baker, Felix Frankfurter 146 (1969) (taken from a Frankfurter speech delivered at Smith College, Feb. 22, 1933). The Securities Act of 1933 was successful in encouraging investors to reenter the capital markets. The issuance of new corporate securities had grown from $6.5 billion in 1927 to $9.4 billion in 1929, but it fell off dramatically after the stock market crash to $644 million in 1932 and $380 million in 1933. Bureau of the Census, Historical Statistics of the United States: Colonial Times to 1970 1006 (1975). However, after adoption of the Securities Act of 1933, new corporate securities issues quickly increased to over $2.5 billion in 1935 and over $4.3 billion in 1936. Goldschmidt, Registration under the Securities Act of 1933, 4 Law & Contemp. Probs. 19, 28 (1937).
[18] Charles Schwab and Walt Bettinger, Why Individual Investors Are Fleeing Stocks, Wall Street Journal Editorial, July 10, 2013, available at http://online.wsj.com/news/articles/SB10001424127887323582904578484810838726222?mod=dist_smartbrief.
[19] Id.
[20] Eric Onstad, Analysis: 'Slow Frequency' Technology Faces Tough Shift from FX to Stock Markets, Reuters, October 2, 2013, available at http://www.reuters.com/article/2013/10/02/us-hft-curbs-analysis-idUSBRE9910PJ20131002.
[21] Id.

Congress could also study the numerous electronic "glitches" that have plagued the markets with market shutdowns and price instability. Many have called for mandatory "kill switches" to stop trading when problems occur, but we believe more aggressive steps should be taken to ensure that our markets are protected. If such havoc can be wrought from innocent errors by companies who have every incentive to get things right, then we worry what could be done by someone with a malicious intent to harm the markets or the country.

<u>Improving Investment Adviser Oversight and Preserving Investor Choice</u>

Finally, state securities regulators continue to support legislation introduced in the House by Ranking Member Maxine Waters that would authorize the SEC to collect "user fees" from federally registered investment advisers, and to use the revenue derived from these fees to fund more frequent examinations of such advisers. We would also like to congratulate Congressman Keith Ellison for introducing the Investor Choice Act of 2013, H.R. 2998. This bill preserves an investor's right to access the court system if the investor has a dispute against a broker or investment adviser. H.R. 2998 is a direct response to the longstanding practice in the broker-dealer industry, and most recently among investment adviser firms (despite advisers' fiduciary duty), of including mandatory pre-dispute arbitration agreements in client contracts. Retail investors deserve a choice, not a mandate, when it comes to disputes affecting their financial portfolios.

Taken together, these two bills constitute major steps that Congress could take today to restore investor confidence in the fairness and soundness of our securities markets, and those who they trust to invest their retirement and savings in these markets.

Thank you again, Chairman Garrett and Ranking Member Maloney, for the opportunity to appear before the Subcommittee today. I would be pleased to answer any questions that you may have.