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at

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Chairman Garrett, Ranking Member Maloney, and Fellow Members of the Committee:

Introduction

I thank you for inviting me. I have comments on eight of the proposed bills. I have a few general comments before addressing the specifics of the bills as time allows. First, although the bills can broadly be characterized as degulatory, deregulation gives something up and it must be thought through carefully. I believe that the bills generally were prepared without appropriate regard to the opportunities for abuse, and without regard to the way the proposals would interact with other relatively recent deregulations. For instance, some of them need to be carefully reconsidered in light of the fact that Rule 144 now permits completely unregulated resales following a reduced holding period satisfied with generous tacking rules. Some need to take into account the JOBS-Act changes to Section 12(g) of the '34 Act that exclude what could be a very large number of investors from counting in determining which entities must register under the Act. The new rules, in the wrong hands, essentially could render registration under one or both of the '33 and '34 Acts optional, and it is not hard to imagine which option would be taken. I also am concerned that some of the proposals do not work coherently together, pushing for modernization on one hand and fighting it on another.

I'll now move to the specifics of the bills. Because my time is limited, I will start with the ones that I believe are most flawed and create the most opportunity for mischief and move to the ones that are not particularly objectionable but probably are not necessary.

1. The Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2015 (The M&A Brokers Bill) (H.R. 686)

I'll align myself with Oliver Wendell Holmes and say I believe that to know what a law is you must look at it as a bad man – updating to include a bad woman. As this bill is drafted it literally would permit someone banned from the securities industry to publicly offer, and ultimately sell, the securities of shell companies to what could be hundreds of people who will, in one year, be permitted to resell the securities without any limits whatsoever. I don't suppose that is what is intended, but that is how it could – and in my opinion would – operate if allowed to pass in its current form.

Some of the defects can be remedied with bad actor provisions, exclusion of the involvement of most shells, and limiting all public offering activity, not just activity involving reporting companies. The SEC's M&A No Action Letter of early 2014 helpfully outlines possible improvements and most probably makes any legislation unnecessary.

Still, even if improved along the lines of the SEC's No Action Letter, what you are left with is a bill to allow unlicensed brokers who, if not registered as investment advisors, are federally unregulated, to compete with those who have put in the time and effort to register and who *are* willing to submit to inspection and other controls. The argument for deregulation supposes that this will bring down M&A costs for smaller companies, to which there are a few responses. One is that smaller companies might very well be better served by licensed professionals. Another is that the cut-offs for eligible privately held companies who need a price cut is extremely high. This relates to a concern that the provision, even if improved, has potential for exploitation by large private equity firms who already are pressing the envelope as far as avoiding registration is concerned. I do not doubt their ingenuity in structuring transactions that could capitalize on this exemption.

Another argument advanced for this particular deregulation is that whether an M&A transaction involves assets or securities may be driven simply by tax or other considerations. The counter to that is "so what?" It may be very well understood from the beginning that the sale of securities will be involved. In any event, if securities are sold, the securities laws should apply unless there is some better justification than “the transaction could have taken some other form.” Isn’t it often the case that issuers that sell stock could have borrowed from banks instead?

In light of the time limitation, I will note that my written testimony at this point describes a number of technical issues, and move on to the next bill.

The technical issues presented by H.R. 686 include the following:

(1) There is no exclusion of bad actors.

(2) There is no exclusion for the placement of shares of shell companies (as opposed to the use of a shell created for purposes of accomplishing a legitimate corporate combination).

(3) Proposed ’34 Act Subsection (15)(b)(13)(B)(ii) is evidently intended to permit exempt brokers to engage in the public offering of the shares of non-reporting companies. This is inconsistent with existing law and should be prohibited.

(4) Proposed Subsection 15(b)(13)(D), among other things, defines “control” and establishes certain presumptions. I recommend that instead of starting “In this paragraph:” the sub-section should start with “For purposes of this paragraph only:” in order to more clearly avoid use of the definition as an analogy in other situations. In addition, the subsection presumes control on the part of any member of a limited liability company. This is not warranted. The limited liability company form readily lends itself to passive members and publicly traded memberships. In addition, the subsection presumes control based on two 20 percent tests, which is quite a low level. Certainly control *may* exist at that level, but it should not for this purpose be presumed unless it is more likely to exist than not – and to me, that means majority ownership. Below that level, it does not seem to me to be too burdensome to require the broker seeking the exemption to satisfy him- or herself that control actually will transfer. Moreover, the final clause

of the control definition presumes control based on the amount a partner or limited liability company member has invested. Since general partners and limited liability company members already are presumed to have control, the net effect of this addition is to assume control by limited partners, which is perverse.

(5) Proposed Subsection 15(b)(13)(D) also defines “eligible privately held company.” The financial tests (which I believe are set too high) are to be satisfied “In the fiscal year ending immediately before the fiscal year in which the services of the M&A broker are initially engaged . . ..” This obviously anticipates that a company might outgrow the limits while the M&A broker is trying to broker a deal. It is a fine idea to address the situation for purposes of clarity, but better to have the test apply throughout the time the broker serves. This would appropriately discourage, but not forbid, the use of an unregistered M&A broker in a borderline case.

(6) Proposed Subsection 15(b)(13)(D) also defines “M&A broker.” The first part of the definition literally permits the sale of securities without being limited to the M&A context. It could be improved by changing “transfer of ownership” to “transfer of ownership representing control.” The existing breadth is supposed to be constrained by a series of “reasonable belief” tests, with no stated requirement of verification. For purposes of comparison, consider current Rule 506, which permits general solicitation on behalf of an issuer if sales are made only to accredited investors and sets out a verification requirement. In addition, one of the things a broker must reasonably believe is that those acquiring securities “acting alone or in concert, will control and, directly or indirectly, will be active in management.” As a strict literal matter, hundreds of investors could act in concert to control if a sufficiently large percentage of ownership is being offered. This would even be presumed to be the case (see above) if limited liability company memberships are involved. Moreover, how is one “indirectly” active in

management? Even a requirement that one be directly active in management would be vague. This is problematic insofar as many limited liability company operating agreements provide for participation in management by all members, even when there are hundreds of members and it is perfectly obvious that very few will actually participate. (*See*, *e.g.*, U.S. v. Leonard, 529 F.3d 83 (2008)) Finally, there is no time constraint with respect to either the exercise of control or participation in management. As written, the provision would permit a broker who reasonably believed the tests would be met for a single day before the securities were re-sold to take advantage of the exemption.

(7) The final set of difficulties with Subsection 15(b)(13)(D) relate to the provision of information to purchasers. The concept of making information available prior to someone becoming legally bound is ill-suited to the context of many genuine M&A transactions – those involving collective decision-making. There, information should be provided a reasonable period before a vote is taken. Even in the case of individual decision-making, information should be delivered sufficiently in advance for reasonable contemplation. In addition, the information to be delivered should be more clearly enumerated. As it is, the language could be read as requiring a recent balance sheet and other information to be delivered only if the issuer has audited financial statements, which I do not believe is the intent. Finally, the allusion to information pertaining to the management, etc., should be an allusion to all *material* information.

<u>2. The Reforming Access for Investments in Starup Enterprises Act</u>

<u>(The Resales to Accredited Investors Bill) (H.R. 1839)</u>

I start my evaluation of this bill with the proposition that the common law Section 4(a)(1½) exemption is not broken and does not need to be fixed. This is particularly true in light of the relaxation of Rule 144, which now imposes only a holding period test before securities can be widely and freely remarketed. Issuers are not permitted to take advantage of the proposed exemption, but as written it would be a perilously easy way for affiliates to flip securities either on their own behalf or the issuer's behalf, providing only that separate compensation for the service is not received. One can easily imagine, as well, that since accredited investors purchasing in a Rule 506 offering would be able to quickly resell on an accredited investor "platform," representations about investment intent would become meaningless. First tier and subsequent purchasers would assume no real holding risk and could be expected to evaluate their purchases less carefully. In addition, one could imagine issuers placing securities directly with accredited investors who indeed were willing to wait out the applicable Rule 144 holding period while hedging their risks. Registration under the '33 Act thus could be made optional.

There are other problems with the bill, including its failure to invoke bad actor and similar protections. In fact, it completely ignores the type of protection associated with private placements under Rule 506 and/or the existing resale rule of Rule 144A. The latter is particularly startling, since Rule 144A allows resales only to qualified institutional buyers – institutions with portfolios of $100 million or more or meeting certain other tests – whereas the bill would allow resales to much smaller, and presumably less sophisticated, buyers, including individuals who have one million in net worth.

Moreover, this bill would permit affiliate resales to accredited investors without the provision of information that the affiliate doubtless possesses, as well as permit "first-tier" accredited investors who received information from the issuer to resell without passing that information along. There is no reason for this, suggesting one more reason for sticking with 4(a)(1½). Lawyers giving advice on 4(a)(1½) transactions traditionally have advised as closely paralleling a Section 4(a)(2) transaction as possible – including provision of available information.

Again, I will refer to more technical comments in my written testimony and move on, noting that the bill is remarkably flawed in a number of ways. It could be improved, although it is not clear why it would then need to exist.

My technical comments on the resales to accredited investors bill include:

(1) It should include protections no less than those provided under Rule 144A. Rule 144A requires the seller possess a reasonable belief as to the status of its purchaser, and provides guidelines. It also excludes securities listed on a national securities exchange or quoted in an automated inter-dealer quotation system (and certain other securities). Rule 144A requires buyer notification *and* requires non-reporting companies to provide certain information which, if requested by the buyer, must be received at or prior to the time of sale.

(2) It should include protections no less than those provided under Rule 506. These include a reasonable belief provision, restrictions on resale, and bad actor limitations.

(3) I specifically endorse the renumbering of the second Section (b) of ’33 Act Section 4. I also would suggest that if Section 18 otherwise is to be amended (which I do not recommend), all of the cross references to Section 4 be updated.

(4) Proposed Section 4(d)(1) permits general solicitation if sales are over platforms available only to accredited investors. General solicitation should be prohibited if there is to be any genuine attempt to keep 4(a)(7) markets limited. An exception could be made for general solicitation over a platform taking the steps required in Rule 506(c)(ii) to assure that all participants are accredited investors. In addition, “platform” should be defined.

(5) Proposed Section 4(d)(2) states that securities sold under Section 4(a)(7) “shall be deemed to have been acquired in a transaction not involving any public offering.” If this is intended to link the provision to Rule 144(a)(3) it should specify that there is a chain of transactions from the issuer or an affiliate. As it is, it leaves open the argument that someone purchasing from an accredited investor who is not an issuer or affiliate did not receive restricted securities. If it is intended to make it clear that since there is no public offering there is no distribution, and thus application of Section 4(a)(1) might be more likely, it is unnecessary as new Section 4(a)(7) would state its own exemption.

(6) Proposed Section 4(d)(3) would permit affiliates to resell securities without any worry that they are underwriters, creating a clear opportunity for abuse. In general, limiting the concept of underwriter to “persons receiving compensation from the issuer with respect to such sale” creates unfortunate ambiguity. For instance, how about someone who simply buys securities at a reduced price with the full intent of selling them to the public six short months later? Moreover, requiring compensation for underwriter status is a mischievous tinkering with the accretion of years of authority on the definition of “underwriter.”

(7) Eliminating state authority over resales to accredited investors is unfortunate and unnecessary. Rule 144A does not preempt state regulation; nonetheless, the Rule 144A market has thrived.

(8) The new exemption should require that the seller not have purchased with a view to resale, and the purchaser should be required to represent investment intent.

<u>3. Encouraging Employee Ownership Act of 2015</u>

<u>(The Rule 701 Bill) (H.R. 1675)</u>

I will frankly align myself, not just with Oliver Wendell Holmes, but also with the Supreme Court in SEC v. Ralston Purina, 346 U.S. 119 (1953). There is no reason to believe that prospective investors who are employees of the issuer need less protection than other prospective investors. If anything, they are more vulnerable to coercion and suggestion. Thus, in 1999 I did not see the merit of excusing issuers of less than $5,000,000 of securities from the very moderate disclosure requirements then added to Rule 701. Even as it is, failing to require information to be given to all prospective employee purchasers creates inequity between employees who do have access to the information registration would provide and those who do not, as well as inequity between uninformed employees and other minority shareholders who might have received information pursuant to other exemptions. Accordingly, I think increasing the limit is a bad idea, and one that can't be excused simply by talking about inflation. Things have changed since 1999 in addition to the value of a dollar. We now have an amendment to Section 12(g) of the '34 Act that says purchasers under 701 don't count for triggering registration requirements. Large issuers thus could sell up to $10,000,000 of securities every year to an unlimited number of employees who would *never* be entitled to information about the company under either the '33 or '34 Acts. At inception, Rule 701 was intended for use by small start-ups and allowing free-wheeling use by larger issuers is unjustified.

I am aware that Professor John Coffee from Columbia University testified on a similar, but even more extreme, proposal last year. I am in complete agreement with him, and will quote him to the effect that "there is little hardship or burden in giving your financial statements to your employees. . . . It may seem a nuisance to an issuer to provide disclosure when its Rule 701 sales are minimal but if the sales fall into the $5 to $20 million range, this is a major (and probably recurring) activity for the issuer."

I suppose that some may cite confidentiality concerns if financial information is put into the hands of employees. If that were the case, requiring disclosure for issuances over $10 million should be more concerning than for smaller issuances, since more employees presumably would be involved. Moreover, when you think about the logic of the non-disclosure argument, what you really are saying is "This information is so important it can't get out." Isn't that exactly the kind of information you'd need to make an informed investment decision? In any event, the correct method of dealing with confidentiality concerns is, of course, confidentiality agreements.

4. The Improving Access to Capital for Emerging Growth Companies Act (The EGC Bill) (H.R. 1659)

I have several reactions to this bill (also submitted last year in essentially the same form as H.R. 3623), none of which are favorable. First, I see no reason to reduce the time between public filing and an issuer's road show from 21 to 15 days. As I understand it, the actual average time is a little over 40 days. Moreover, I do see possible mischief if an issuer did try to take advantage of the proposed reduction. Although many EGCs are very large and can be expected to attract fairly immediate attention and analysis, some will be small. Truncating the time for public reaction simply seems like a poor, and untested, idea. The argument necessary to support truncation is that you want EGCs to be able to capitalize on market conditions before they change. This boils down to saying you want them to be able to sell securities before the price comes down, leaving investors holding the bag.

I am also concerned with the part of the bill that would permit EGCs to launch the SEC review process with a single year of financial statements. Financial statements are a critical part of the disclosure package, and the ability to compare years to discern trends is extremely important. I understand the purpose of the bill is to make sure that EGCs never wind up having to provide more than two years of audited financial statements, but starting down the road to SEC review without the ability to compare years is a real strike against efficiency and, ultimately, investor protection. It also is completely unnecessary in any case in which an issuer already has two years of audited financials. At a minimum, issuers should be required to provide what they have. Moreover, I will observe that the requirement that the second year of financial be filed by amendment "before distribution of the preliminary prospectus" is meaningless, given that the public will have access, and begin forming opinions, as soon as the public filing occurs.

Although I have no particularly strong objection to the idea that a company initiating a confidential EGC process should be permitted to complete it even if it is no longer an EGC, I do not see this as a necessary amendment. It is unlikely to be a regularly recurring scenario, and companies that are close to the line probably should be encouraged to step into larger shoes if they think their baby shoes are likely to pinch.

The version of the bill I originally reviewed contained a "follow-on" provision permitting confidential treatment for a second ECG filing within a year, and provided for public filing a mere two days before securities were issued. I understand the bill has been revised to remove the provision, and it is well gone. There should be no reason for a second confidential bite at the apple, and a two day period for the public to form its opinions before *issuance* is more than odd, essentially assuming automatic effectiveness and sale the same day. This may be justified for well-known seasoned issuers, but not for EGCs.

<u>5. The Disclosure Modernization and Simplification Act of 2015</u>

<u>(The Regulation S-K and Form 10-K Bill) (H.R.1525)</u>

The bill proposes that the SEC issue regulations permitting issuers to submit a summary page on Form 10-K with cross-references (by electronic link or otherwise) to the material in the

Form 10-K. This strikes me as unobjectionable, but probably unnecessary. I believe cross-reference sheets already are permissible, and I believe analyst attentiveness and demand will prevent sliding down some slippery slope to vestigial 10-K reports.

I do object to the approach of the rest of the bill. The "act now, then study, then report and then act again" mandate to revise is no way to conserve, much less maximize, administrative resources. More important, re-examination of Regulation S-K already is underway, and the periods specified for various milestones are, by-and-large, unrealistic. I am sure we all recognize the Commission's difficulty in responding to the various Dodd-Frank Act provisions ordering implementation in particular time-frames. Intended or not, tenewal of this approach comes across as a somewhat mean-spirited attempt to embarrass an agency that has long been held in high esteem – and could serve to distract the Commission for the foreseeable future from its other significant tasks. In addition, the tone of the mandate overwhelmingly cuts in favor of limiting disclosure. I am concerned that the Commission might feel itself constrained from adding disclosure requirements that might be well-advised, such as specific (and needed) augmented disclosures with respect to short-term borrowing. Finally, as someone who in the 1970s heard vacuous exhortations like "more nuclear power, but safer," I can only say that the exhortation to "emphasize a company by company approach that allows relevant and material information to be disseminated to investors without boilerplate language or static requirements while preserving completeness and comparability of information across registrants" seems to be – how shall we say? – not particularly helpful. Again, it is needlessly insulting to a diligent and esteemed agency to suggest that they do not already have these concerns close to heart and that they are not trying to address them on an ongoing basis.

<u>6. XBRL and Small and Emerging Growth Companies</u>

(The XBRL Bill) (H.R. 1965)

It is somewhat perplexing that the S-K proposal urges modernization, while this exemption for EGCs from the requirement that financial statements be filed in Extensible Business Reporting Language (XBRL) is a step backward. This would permit a very large number of filers to avoid filing information in a manner that would permit it to be compared to the information of other filers – both those that are larger and those in the same size range (of under one billion dollars of gross revenue). This puts investors at a disadvantage. This puts analysts at a disadvantage. This puts the Commission at a disadvantage. It puts prospective academic researchers at a disadvantage. It may even put EGCs that don't file in XBRL at a disadvantage if investors can acquire information about other issuers more easily. In addition, although there is expense associated with XBRL, there is no reason to think it is any different than any other technology. XBRL will become easier and cheaper the more it is used.

7. Small Company Simple Registration Act of 2015

(The S-1 Forward Incorporation by Reference Bill) (H.R. 1723)

As noted by Professor John Coffee's testimony last year, the Commission's Government-Business Forum on Small Business Capital Formation has for some time called for changes to permit smaller reporting companies that have registered an IPO on Form S-1 to incorporate by reference other documents filed with the Commission. I believe something is lost in terms of SEC review of the documents reviewed, but acknowledge something is gained in cost savings. If the change is made, however, it should prompt reflection on the manner in which the entire package of information actually is made available to investors. The Commission's Electronic Data Gathering and Retrieval (EDGAR) system is an awkward and not very user-friendly research tool. Funding of a project to retool the system would be applauded in many quarters. In addition, recognition of EDGAR's limitations prompts me to suggest that if the bill goes forward it specify that the issuer post an S-1 on its website that will be updated with a hyper-link to each document incorporated by reference at the time the document is filed.

<u>8. Section 31 Fee Overpayments by Exchanges and Finra</u>

<u>(The Overpayment Bill (H.R. 1975)</u>

I certainly do not oppose the reasoning of this bill, but I do urge that some thought be given to the actual mechanics of the cash flow. I assume that the overpayments meant to be addressed will have been spent or forwarded elsewhere. The money foregone in the future will have to come from some source, which should be identified.

<u>Summary</u>

I reiterate my concern that a number of the bills will lead to unanticipated abuse. I also note that the package of bills works to reduce disclosure in a number of ways. For instance, there predictably will be less disclosure of broker conflicts, less disclosure when securities are re-sold to accredited investors, less disclosure to employees, less comparability of disclosure by EGCs and less time for EGC disclosure to be considered. It is important to remember that reducing disclosure increases investor risk. Reasonable investors considering that risk well may factor it into pricing determinations. As a result, I believe it would be impossible to conclude that this packet of proposals would positively affect capital formation .