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

SEPTEMBER 23, 2004

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

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

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

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

SEC Resources for Small Businesses

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

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

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

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

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

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

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

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

Government-Business Forum on Small Business Capital Formation

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

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

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

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

Regulation for Small Businesses

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

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

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

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

[3] 17 C.F.R. § 230.251-263.

[4] 17 C.F.R. § 230.501-508.

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

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

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

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

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

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

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

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

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

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

Sarbanes-Oxley Act of 2002

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

- We gave small business issuers extra time to comply with the rule requiring disclosure of whether they have a financial expert on their audit committees.

- We gave public companies with less than $75 million in market capitalization additional time to comply with the rules requiring a report on internal control over financial reporting. As a result, this requirement will apply for the first time to most small business issuers for filings they make in 2006.

- In the adopting release for the internal control rules, and again in recent staff guidance on Frequently Asked Questions (or FAQs) about the rules published on our Web site, the

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

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

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

Other Initiatives Benefiting Small Businesses

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

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

- Public companies with less than $75 million in market capitalization are exempt from the new accelerated deadlines adopted in September 2002 for quarterly and annual reports.

- Small business issuers are not required to include in their periodic reports the table of contractual obligations that is required for other issuers under rules adopted in January 2003.

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

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

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

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

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

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

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

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

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

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

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

Conclusion

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

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