Written Testimony

of

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to the

Committee on Financial Services,

Subcommittee on Capital Markets and Government Sponsored Enterprises

U.S. House of Representatives

"Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation"

SEPTEMBER 21, 2011

Good afternoon Chairman Garrett, Ranking Member Waters, and Members of the Committee. My name is Barry Silbert. I am the Founder and CEO of SecondMarket. I am grateful for the opportunity to testify this morning regarding these important subjects that pose significant challenges to our country. The issues raised in my testimony directly impact startup growth, job creation and American global competitiveness.

First, I'd like to describe SecondMarket. Second, I will discuss the problems in the public stock markets that have made the markets inhospitable to growth-stage companies. Next, I will describe the important role that SecondMarket plays in the capital formation process and in affording access to capital. Finally, I will suggest passage of the legislation that is the subject of today's hearing, particularly the bills that support growing private companies on their road to the public markets, while also maintaining a high level of investor protection.

My Background and the SecondMarket History

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

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

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

The first asset class that we focused on was restricted securities in public companies. These are assets such as restricted stock, warrants and convertibles that are issued by public companies but not tradable in the public stock markets. Since that time, SecondMarket has experienced significant growth, and we have added several more asset classes that benefit from our core principles of transparency, centralization and independence.

What do these principles mean? Transparency means providing detailed information about the asset so that buyers and sellers can make informed investment decisions. It also means transparency into asset pricing. Centralization means bringing together buyers and sellers in a formalized, secure marketplace. Independence means we are not a subsidiary of another financial institution and, more importantly, we do not engage in proprietary trading. Thus, we do not use our own balance sheet to complete transactions. We are willing to sacrifice short-term revenue opportunities because we believe that as a global marketplace, it is critically important that our participants recognize that we are not on either side of the transaction. We are always the marketplace connecting buyers and sellers, guiding our participants through the sales process, and handling the closing and settlement of the transactions.

Since launching the first asset class in 2005, we have added markets for fixed income (*e.g.*, auction-rate securities, mortgage-backed securities, etc.), bankruptcy claims and private company stock. These asset classes have unique characteristics, objectives and participants. However, they share the common thread that they are illiquid, alternative investments that benefit from a centralized marketplace.

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

Moreover, we are no longer a few individuals in a small office. SecondMarket now employs nearly 150 people in New York and San Francisco, and we are hiring new employees every month. I should also note that SecondMarket is a FINRA registered broker-dealer and operates an SEC-registered Alternative Trading System for its private company stock market.

SecondMarket is the leading marketplace for facilitating transactions in private company stock. We have completed trades in over 60 different companies, including Facebook and Twitter. In 2008, we completed $30 million in private company transactions. In 2009, that number rose to $100 million and in 2010, we saw nearly a four-fold increase in transactional value. To date, we have completed over $850 million in private company stock transactions. Across all of our asset classes, we have completed several billion dollars in trades.

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

Problems in the Public Stock Markets

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

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

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

- Online Brokers – although the introduction of online brokerages helped to make trading less expensive, these online brokers disintermediated retail brokers who helped buy, sell and market small-cap, under-the-radar public companies to investors. Stockbrokers collectively made hundreds of thousands of calls per day to their clients to discuss small-cap equity opportunities, and the proliferation of online brokerages decimated the profession. Those brokers provided a critical marketing tool for the country's small-cap companies.
- Decimalization – stock prices used to be quoted in fractions, and the difference between fractions created profit for firms providing market making, research and sales support to small-cap, public companies. When the markets began quoting prices in decimals, trading spreads were reduced and profits were significantly cut. It became unprofitable to market small-cap equity.
- Sarbanes-Oxley – the legislation is often blamed for the problems in the public markets, but many observers believe it is not the most significant factor in companies electing to remain private. Nonetheless, corporate compliance with the Sarbanes-Oxley Act has certainly increased costs, especially for smaller public companies.
- Global Research Settlement – once the investment banks began funding equity research, conflicts of interest emerged and positive equity reports began to be written for undesirable companies. This issue caused state Attorneys General to get involved, eventually resulting in the global research settlement. While based on sound public policy, the result was that research reports essentially stopped being written for small-cap public companies and, consequently, a significant marketing mechanism for small-cap companies was eliminated.

- High-Frequency Trading – although high-frequency traders bring significant liquidity to the public markets, by definition, they require the volume and velocity that can only be found in large public companies. A recent report stated that high-frequency traders conduct almost 75% of the trades taking place in the U.S. equity market, and those traders essentially ignore small-cap companies.[2]
- Average Hold Period – over the past forty years, the average time that a public market investor holds stock has dropped from approximately five *years* in 1970, to less than three *months* today. This further highlights the fact that investors are now focusing their attention on short-term earnings performance, versus long-term, business-building initiatives.[3]

Virtually all of these developments emerged from either well-intentioned policy decisions or the natural evolution of the markets in an electronic age. Nonetheless, taken in the aggregate, these (and other[4]) factors have made the public markets undesirable for many companies. These factors are not temporary and are unrelated to the current economic climate. These changes to our public stock markets are permanent and systemic, and the regulatory regime must reflect that permanence.

[2] "Institutional Traders Around the World Concerned by High-Frequency Trading, Global Survey Shows," *MarketWatch*, Sep. 2011 (According to the Tabb Group, almost 75% of overall daily equities trading can be attributed to high frequency trading.).

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

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

Throughout the 1980's and 1990's, the regulatory environment and overall market structure actively supported high-growth private companies joining the public markets. From 1991 to 2000, there was an average of 520 IPOs per year, with a peak of 756 IPOs in 1996. Today, the lack of a properly functioning public market structure is strikingly obvious. Since 2001, the United States has averaged only 126 IPOs per year, with 38 in 2008, 61 in 2009 and 71 in 2010.[5]

Companies are electing to remain private longer than in previous decades, and the average time a company remains private has essentially doubled in recent years.[6] Moreover, the profile of companies going public has dramatically changed. Today, only the very largest companies are going public, and are receiving the sales and research support needed to successfully navigate the public markets.

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

Consider that roughly 3,000 companies receive funding each year, yet only 100+ companies annually are going public. Putting aside those that are acquired and others that failed, there still are numerous private companies that need improved access to capital. Clearly, a new growth market must emerge.

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

[6] *Id.*

The SecondMarket Solution

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

The SecondMarket approach is premised on the notion that there is not a "one-size-fits-all" model for private companies. Each company has its own goals and objectives. Some companies value control and flexibility, others are more concerned with liquidity and valuation. Our business model is premised on the fact that we will not facilitate transactions in a company's equity unless that company has authorized us to do so.

In that context, we allow companies to dictate the essential elements of their marketplace, such as identifying eligible buyers and sellers, setting the amount or percentage of shares to be sold, and determining the frequency of transactions. Some companies want only former employees to sell, and some want only existing shareholders to buy. Some permit weekly trading, but many prefer to establish quarterly or annual liquidity events. Some choose to allow an open market where buyers and sellers negotiate the share price on a one-off basis, and some elect that we run an auction to establish a clearing price.

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

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

Suggested Regulatory Changes

SEC Chairman Mary Schapiro has said that the SEC is reviewing the regulatory landscape to lessen the burdens on private companies. In this year's State of the Union address, President Obama ordered a review of all government regulations. He added: "When we find rules that put an unnecessary burden on businesses, we will fix them."[7] This month, in his address on job creation, the President was even more pointed in his remarks: "We're also planning to cut away the red tape that prevents too many rapidly-growing start-up companies from raising capital and going public."[8]

I applaud the focus of the Administration, and I believe that the "red tape" that the President identified can be cut away with legislation that enjoys strong bipartisan support. Rule changes in

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

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

this area would directly impact companies' ability to access capital more readily and cheaply, help companies retain existing employees and hire new ones, and bolster American global competitiveness. At a time when our lawmakers, policymakers and regulators debate how best to create new jobs, I believe a few minor changes to the regulatory rules could have a major impact on job creation.

It may be commonly understood that venture-backed companies fuel job growth in this country,[9] but most people do not appreciate the staggering extent to which the statement is true. In its 2010 study entitled *The Importance of Startups in Job Creation and Job Destruction*, the Kauffman Foundation noted that startups create an average of three million new jobs annually and the most new net jobs in the United States.[10] The study bluntly states: "Put simply…without startups, there would be no net job growth in the U.S. economy."

Thus, it is essential that the regulatory framework recognizes this dynamic and permits these startups to flourish. Every member of Congress is concerned about job creation. It is the foremost concern of President Obama and virtually all Americans. Policymakers need to understand that any serious effort to create jobs has to address the concerns of entrepreneurs. The Kauffman study concludes by noting that "States and cities with job creation policies aimed at luring larger, older employers can't help but fail, not just because they are zero-sum, but because they are not based on realistic models of employment growth. Job growth is driven,

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

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

essentially entirely, by startup firms that develop organically…effective policy to promote employment growth must include a central consideration for startup firms."

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

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

These two regulatory restrictions have been in place for several decades. The shareholder threshold – which, incidentally, was initially set at 750 before being reduced – was established in 1964 and worked quite well for several decades. For many years, companies were going public within a few years of founding, and were rarely concerned about exceeding the shareholder threshold. That, however, is no longer the case.

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

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

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

This is particularly relevant when considering "crowdfunding" legislation, which the President has supported in concept. Raising small amounts of capital from many investors is extraordinarily difficult with only 500 investor slots. While I certainly support creating a crowdfunding exemption to the securities laws, crowdfunding is only a viable fundraising option if the 500 Shareholder Rule is revised and additional slots are created.

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

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

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

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

I believe that all five bills being considered today are important for our country's entrepreneurs and will help improve access to capital for startups. However, I wish to focus on two of the bills that I believe warrant immediate passage by this Congress:

1. "The Private Company Growth and Flexibility Act" (H.R. 2167), which increases the 12(g) shareholder threshold from 500 to 1,000. This bill also includes two important exemptions from the shareholder count: (1) current and former employees who received equity under an exempt equity compensation plan and (2) accredited investors.[11] This bill was introduced by Representatives Schweikert and Himes, and enjoys broad bipartisan support.

[11] Both classes of shareholders would be excluded from the shareholder count, allowing private companies the flexibility needed to successfully grow their businesses. The SEC has determined that employees taking shares under an exempt equity compensation plan and accredited investors do not require registration-level protections. Thus, implementation of this exemption would not breach the SEC's investor protection mandate.

2. "The Access to Capital for Job Creators Act" (H.R. 2940), which eliminates the ban against general solicitation and advertising in the context of issuer private placements under Rule 506 of Regulation D, provided that the ultimate purchaser qualifies as an accredited investor.

These proposals are extremely important but are not new concepts: industry experts and participants have advocated for implementing these changes for many years.[12] In 2009, the SEC kindly invited me to participate in its Small Business Capital Formation Forum. I accepted the invitation and participated on a panel regarding the state of small business capital formation. I also listened to multiple panelists advocate for some or all of these changes. In fact, for several years, the Forum's participants have recommended that the SEC increase the shareholder threshold, and for over a decade the participants have recommended that the SEC eliminate the ban against general solicitation in the context of private placements.

I recognize that passage of the Dodd-Frank Act significantly added to the SEC's rulemaking responsibilities, and implementation and enforcement of these new rules will be challenging. Nonetheless, I believe the problems facing growth-stage companies in this country must immediately be addressed, and these narrowly tailored, straightforward bills are steps in the right direction.

While I do not have the expertise to opine at length about the other bills under consideration today, I also support policy changes to create an exemption to the securities laws to permit

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

crowdfunding, allow community banks to have 2,000 shareholders, and ease the compliance requirements for Sarbanes-Oxley. I also support the legislation put forth by Rep. Schweikert and endorsed by the President to increase the cap on "mini offerings" under Regulation A from $5 million to $50 million.

Conclusion

In summary, I want to thank Chairman Garrett, Ranking Member Waters, and the members of the Committee for the opportunity to participate in this important Hearing. I also want to thank the SEC for consideration of these rule changes.

Thank you.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Barry E. Silbert	SecondMarket Holdings, Inc. and its subsidiary SecondMarket, Inc., a registered broker-dealer

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

N/A

7. Signature:

Barry E. Silbert

Please attach a copy of this form to your written testimony.