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at

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of the

Committee on Financial Services

of the

United States House of Representatives

"Legislative Proposals to Enhance Capital Formation for Small and Emerging Growth Companies"

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

Introduction

I thank you for inviting me. I have been asked to comment on seven proposed bills, some of which appear to be a still early stage of drafting. Reasonable people can disagree about several of these provisions, but others are beyond the pale. Still, my overarching comment is that each of these bills represents a piecemeal attempt to "tweak" something in our existing system, but collectively they are uncoordinated and lack any consistent vision. If there is any common theme to these bills, it is that better integration and coordination is desirable between our twin disclosure regimes under the Securities Act of 1933 and the Securities Exchange Act of 1934. That could well be true. If so, the appropriate starting point might be to mandate a study by the SEC (within, say, a realistic two-year period) of how to better coordinate both (1) these two disclosure systems, and (2) public and private offerings. Absent such an attempt at coordination, we will obtain only piecemeal (and fumbling) reforms that resemble the seven blind men groping at the elephant. In particular, as these proposals suggest, private placements may soon overtake public offerings—without adequate attention being given to the appropriate role of each.

More generally, we seem to be moving from JOBS Act I to a JOBS Act II without any serious evaluation of the impact of the first round of changes. On balance, the JOBS Act may have had only modest impact, and the proposals that are being considered today will likely have less. Because my time is limited, I will analyze these proposals in terms of the intensity of my reaction, moving from those that I feel are likely to cause real harm to those that are understandable (but that probably do not require legislation). I will begin with a provision (the definition of "well-known seasoned issuer") whose impact has not been adequately or candidly explained.

1. The Definition of "Well-Known Seasoned Issuer." This may be the most radically deregulatory of the seven proposals now before this Subcommittee, but it has not been adequately explained just how far reaching this proposal would be. The proposal derives from the 2011 Report of the SEC Government-Business Forum on Small Business Capital Formation, where it was the 19th out of 25 recommendations made by that body. Frankly, it received only lukewarm support.[1] The recommendation there made was to:

> "Expand the availability of the special public offering provisions currently applicable only to "well-known seasoned issuers" (WKSIs) to all public companies, including smaller reporting companies and foreign private issuers. This would permit such companies to, <u>among other things</u>:
>
> a. File a universal shelf registration statement;
> b. Test the waters;
> c. Pay as you go; and
> d. Use forward incorporation by reference for Form S-1 registration statements."
>
> (Emphasis added)

Each of these "benefits" can be debated. For example, a WKSI is exempt from the "gun jumping" and "quiet period" restrictions of Section 5(c) of the Securities Act of 1933, and there can be reasonable debate about the wisdom of freeing smaller companies from these rules. Still, the key implication of expanding the definition of "well-known seasoned issuer" has not been explained: it would permit the majority of public

[1] See Final Report of the SEC Government-Business Forum on Small Business Capital Formation (November 17, 2011) at p. 31. This recommendation received an average ranking of 2.92 (whereas some recommendations received a perfect score of 4.00 and the lowest score for any recommendation was 2.34)

companies to qualify for "automatic shelf registration." This may not have been the intent, but it is the consequence.

Under Rule 405, a "Well-Known Seasoned Issuer" generally qualifies for "automatic shelf registration." Since 2005, the instant that a "well-known seasoned issuer" files a registration statement, the registration statement becomes "effective" and the securities can be sold under it—without any prior SEC review.[2] As a practical matter, allowing a company to qualify for automatic shelf registration both (1) denies the SEC's staff any opportunity to review and correct the registration statement before sales are made, and (2) makes it much more difficult for the issuer, its investment bankers, and its other agents to conduct a pre-offering "due diligence" review of the registration statement's contents (because there no longer is a pre-offering period between the filing of the registration statement and its effectiveness). Further, the SEC has a substantial staff in its Division of Corporation Finance that conducts a pre-effectiveness review of the registration statement and engages in a dialogue with the issuer.[3] This provision short-circuits that review and largely renders them irrelevant for such issuers.

At present, a "well-known seasoned issuer" (or "WKSI" in the parlance) basically must either (i) have a "public float" of at least $700 million (that is, the worldwide market value of its common equity, voting and nonvoting, held by non-affiliates must equal or exceed $700 million), or (ii) have issued over the last three years $1 billion in non-convertible debt securities. These are high standards. By some estimates, only about a third of the issuers on the NYSE meet this standard.

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[2] See General Instruction ID(5) to Form S-3.

[3] Of course, the SEC could lay off this excess staff, in which case this bill should be called the "Anti-Jobs Act."

Under the proposed legislation, the $700 million standard would be reduced to $250 million. At that point, probably a majority of the issuers on both the NYSE and Nasdaq could become WKSIs—and in most cases could use "automatic shelf registration." Many of these issuers might be followed by only a single securities analyst, and do not necessarily trade in an efficient market. The SEC's staff that reviews registration statements would be unable to focus on these offerings and would be left to concentrate on IPOs and very smaller issuers. This seems a poor allocation of the SEC's resources.

Since 1933, prior review by the SEC's staff of the registration statement has been one of the bedrock protections of our federal securities laws. Thus, I suggest to you that it is a fairly radical step to deny the SEC's staff any opportunity for a pre-offering review of the securities to be issued by most issuers. Yet, that is what this proposed expansion of the definition of WKSI does. This result may or may have been intended, but it both invites misbehavior (if an issuer knows it will not be subject to prior review) and encourages costly litigation (if errors are later discovered).

Even if this proposal were cut back so that it only permitted smaller issuers to use "universal shelf registration," I would still have some concerns. When shelf registration was first introduced in 1983, the issuer had to allocate the gross dollar value of its offering to specific types of securities (i.e., debt, equity, warrants, etc.). Then, in 1992, the SEC permitted unallocated shelf registration. In such a "universal" shelf registration, the issuer may pre-register debt, equity and other classes of securities in a single shelf registration statement without any allocation of offering amounts among these classes. In

1992, the SEC lowered the threshold for Form S-3 and universal shelf registration to $75 million (well below the $250 level here proposed).

Thus, smaller issues can already make use of universal shelf registration. What then is achieved by expanding the definition of WKSIs (other than entitling the issuer to use "automatic shelf registration")? A partial answer is that WKSIs can uniquely register securities for sale for the account of selling shareholders without separately identifying "the selling security holders or the securities to be sold by such persons" until the time of the actual sale by such persons. See General Instruction ID(d) to Form S-3. In short, by expanding the definition of WKSI, we facilitate not primary offerings by the issuer, but secondary sales by large shareholders. This does not raise capital for the issuer or create jobs, but essentially encourages a bailout by insiders. Such secondary sales, which do not have to be disclosed in the original registration statement, seem particularly problematic in the case of smaller companies.

To sum up, this provision is not what it seems. It does not simplify the issuer's access to capital, but it does both (i) strip the SEC of its pre-offering review authority, and (ii) facilitate secondary bailouts by insiders.

2. HR 2659 ("Accelerated Filer"). This provision would modify the definition of "accelerated filer" in SEC Rule 12b-2 (17 C.F.R. § 240.12b-2), which today makes an issuer an "accelerated filer" if it has a "public float" of between $75 million and $700 million (that is, the value of its equity shares not held by affiliates). Under the proposed revision, the new test would be moved up to $250 million (instead of $75 million), and in addition the issuer would need to have "annual revenues of greater than $100,000,000 during the most recently completed fiscal year for which audited financial

statements are available" (see Section 2 of H.R. 2629). Thus, many issuers today deemed accelerated filers would escape that label under this revised test, including some with very large market capitalizations.

What is the consequence of this change? First, it will allow many companies to escape Section 404(b) of the Sarbanes-Oxley Act and its requirement of an annual audit of internal controls. The JOBS Act already did this with respect to "emerging growth companies" (at least for a five-year "on ramp"), but this provision would exempt older companies that did not qualify for that exemption. Also, the exemption could continue forever and not just for five years. Second, under the instructions to Form 10-Q, an "accelerated filer" must file its Form 10-Q within 40 days after the end of the fiscal quarter, whereas all other issuers must file within 45 days after the end of the quarter. This is a further small step away from transparency.

If the goal is to cut back further on the scope of Section 404(b), this might best be done directly without causing any other collateral consequences. Still, some estimate should be made of just how many companies will escape Section 404(b) by this back door. Finally, the JOBS Act had a stronger rationale for its Section 404(b) exemption, (namely, that it permitted a temporary accommodation for young and emerging companies), whereas this bill's exemption covers old companies and potentially forever.

3. Raising the Disclosure Exemption Under Rule 701(e) from $5 million to $20 million. Currently, Rule 701 exempts from registration sales by non-reporting issuers of their securities to employees, consultants and advisors (and their family members) pursuant to a written compensatory benefit plan or compensatory contract. Effectively, this rule shelters non-reporting companies from the potentially expensive

obligation to register stock options and similar equity compensation under the Securities Act of 1933. But under Rule 701(e), some minimal disclosure is required, including financial statements and "information about the risks associated with investment in the securities." This limited obligation to provide such information is not applicable if the issuer sells less than $5 million of its securities under this exemption during any consecutive 12-month period. The proposed bill before this Committee would raise this $5 million level to $20 million.

Because the disclosure obligation under Rule 701 is minimal and does not require the preparation of any formal disclosure document, this proposal to raise the exemption by 400% to $20 million seems hard to justify. First, there is no rationale advanced for the $20 million threshold. Second, there is little hardship or burden in giving your financial statements to your own employees. This proposal did not even seem to win substantial support within the small business community (as it has not been regularly cited at the SEC's Government-Business Forum on Small Business Capital Formation).

Further, once the volume of sales under Rule 701 exceeds $5 million and begins to approach $20 million, the cost of providing minimal disclosure falls as a percentage of the total transaction. 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.

4. <u>Expanding the Availability of Form S-3</u>. Today, eligibility for use of Form S-3 (and thus the ability to use shelf-registration) generally requires that an issuer have a "public float" of at least $75 million. See General Instruction IB(l) to Form S-3. In addition, other registrants can use Form S-3 if (i) the aggregate market value of

securities sold by the registrant during the period of 12 calendar months immediately preceding and including the sale does not exceed one-third of its public float (i.e., the aggregate market value of its common equity held by non-affiliates—see General Instruction IB(6)(a) to Form S-3), (ii) the issuer is not a "shell company," and (iii) the registrant has at least one class of common equity registered on a national securities exchange (General Instruction IB(6)(c) to Form S-3). In effect, this alternative test allows listed companies with less than a $75 million public float to use Form S-3, but places a ceiling on the size of the offerings that they may do using Form S-3 that is equal to one-third of their public float. Letting a small company with a modest $50 million public float use shelf registration to attempt to sell $150 million in securities invites potential disaster and investor confusion.

Nonetheless, a bill before this Committee, known as the "Small Company Freedom to Grow Act of 2014" would permit this by eliminating most of these limitations. Effectively, it would allow any company, which is not a "shell company" (as defined in Rule 405) and that has not been a "shell company for at least 12 calendar months, to use Form S-3. Under this provision, even microcap companies could thus use shelf registration and offer securities from time to time in any amount, at least if they were reporting companies and were current in their 1934 filings (to thereby satisfy General Instruction IA).

This would represent a significant change in long-standing SEC policy, and I suggest that Committee consult the SEC to hear its view. Traditionally, shelf registration was limited to seasoned issuers with a sizable market capitalization and an established market following. Under this provision, even companies traded only on the Pink Sheets or the OTC Bulletin Board might use shelf registration and make a sizable offering with no prior notice. As a practical matter, I doubt that the market will accept such offerings or that reputable underwriters will feel comfortable with them, but the door is at least opened (and in a frothy market, anything can happen and has).

5. Blue Sky Preemption. The above-noted "Small Company Freedom to Grow Act of 2014" would also preempt state "Blue Sky" laws in the case of "smaller reporting companies" and "emerging growth companies." Currently, Section 18 of the Securities Act preempts only "nationally traded securities" that are either (i) listed on certain national securities exchanges (under SEC rules that look to their listing standards), or (ii) are issued in certain exempt transactions involving qualified purchasers. This proposal would extend the scope of Section 18's preemption of state blue sky law by an order of magnitude. Potentially, companies traded on the Pink Sheets (or not even traded at all) would be exempted if the issuer was a reporting company.

This makes little sense at a time when the SEC is resource-constrained and cannot challenge every transaction. The cases most likely to sneak under the SEC's radar screen are precisely those involving local or regional companies that are traded over-the-counter, on the OTC Bulletin Board, or on the Pink Sheets. Unfortunately, these are exactly the low visibility companies that this statute would exempt from the scrutiny of state regulators.

Perhaps, the sponsors of this bill see state "Blue Sky" regulators as difficult, overly suspicious, bureaucratic, or prone to delay. I believe such a characterization is unfair. State regulators are hard-working, have more than enough to do, and typically focus their attention on precisely those smaller companies that the SEC is most likely to overlook. Preempting state law simply because an issuer files reports with the SEC places excessive reliance on the SEC and invites fraud and misconduct.

6. Form S-1 and Forward Integration. For some time, the SEC's Government-Business Forum on Small Business Capital Formation has called for changes to permit smaller reporting companies that have filed a Form S-1 to incorporate by reference documents filed with the SEC. Effectively, this would make the Form S-1 "evergreen" in the sense that it would not become stale. Of the various proposals before this Committee, I believe this one does have real efficiency justifications and could help smaller issuers.

Again, I believe the Committee should seek the views of the SEC on this matter, and I do not suggest that Form S-1 should be expanded to become a vehicle for shelf registration (which should instead require that the issuers qualify for the use of Form S-3). But I do see merit in this proposal.

7. Regulation S-K and Form 10-K. The "Disclosure Modernization and Simplification Act of 2014" proposes that the SEC issue regulations to permit issuers to submit a summary page on Form 10-K that would cross-reference (by electronic link or otherwise) the material contained in the Form 10-K. I see no conceptual objection to such a cross-reference sheet, and believe it is already possible. Legislation is thus unnecessary.

I do not believe it is realistic to expect Form 10-Ks to become short and concise. Indeed, securities analysts want them that way because they see them as a treasure trove of valuable data. Form 10-Ks are not aimed at the retail investor, but at the professional: the securities analyst and other intermediaries. Thus, while some simplification may be possible, it is a mistake to believe that the Form 10-K can be made as simple and direct as the summary pages of a prospectus.

Although I certainly do not object to the SEC conducting a study or re-examining its regulations, the 180-day period specified in Section 3 of this proposed bill and the 360-day period specified in Section 4 for such SEC studies and rulemaking are both unrealistic. The SEC is still only about half done with implementing the Dodd-Frank Act (which was passed in 2010) and clearly cannot expedite everything at the same time.

8. Rule 144. The proposal among these bills that seems likely to attract the greatest attention is the one that would shorten the holding period before "restricted securities" may be resold from six month to three months (in the case of an issuer that is a "reporting company"). Presumably, although it is not said explicitly, this shortened period would only apply so long as the issuer was current in all its 1934 Act filings.

A three month holding period in my view is a mere hiccup, and its adoption would greatly decrease the likelihood that a public company would use a public offering after its IPO. Instead, we would see many more PIPE transactions ("Private Investment in Public Equity") in which public companies sell their stock in private placements at prices below the public trading price. For the most part, stockholders resent such transactions (and they generally lead to a stock price decline), but this legislation would encourage PIPE transactions. Indeed, if a three-month holding period were used, I expect that many investors would hedge the stock so acquired over that three-month period and then dump the stock into the public market to realize the locked-in discount in the PIPE transaction. This was the experience under Regulation S when it originally required only a three-month waiting period before resale (and as a result Regulation S was amended to bar the investor from hedging over this period).

This bill also proposes to extend Section 18 of the Securities Act to cover securities sold under Rule 144A. Although I generally dislike the preemption of state "Blue Sky" Law, I can understand the case for this provision, as Rule 144A is a very different type of offering, limited to very large "Qualified Institutional Buyers" (or "QIBS"). Nonetheless, I doubt this provision is really needed, because Rule 144A transactions follow after an earlier Section 4(a)(2) private placement, which is already largely covered by Section 18(b)(4).

9. <u>HR 4200—Registration of Fund Advisors for Venture Capital Funds and SBICs</u>. This bill, denominated the "SBIC Advisers Relief Act of 2014," would amend the Investment Advisers Act of 1990 to expand the exemption under §203(l), which already exempts venture capital fund advisers, to cover persons who are advisers to both venture capital funds and SBICs. It is hard to quarrel with this exemption, but even harder to believe that it will have any serious impact on capital market competitiveness or that it will create jobs.

H.R. 4200 also extends the preemption of state "Blue Sky" authority over investment advisers. In general, I find such preemption undesirable, but, because of the sophisticated nature of venture capital funds, this is less objectionable than the proposed preemptions earlier discussed. That is, however, hardly an endorsement.

10. <u>Crowdfunding</u>. I understand that legislation is to be proposed with respect to the "crowdfunding" exemption of the Securities Act of 1933 (i.e., Sections 4(a)(6) and 4A). I cannot comment because I have not been provided this draft. Still, I would

observe that we have not yet seen a single transaction under the crowdfunding exemption (because the rules are not yet final). Thus, it may be premature to amend it in the absence of any experience. In general, discretion is the better part of valor.

Summary

Some of these provisions essentially would revise SEC Forms S-1 and S-3 or amend specific rules. In my judgment, this is micromanagement. Nor are these bills united by any central vision. Thus, I would again suggest the need for an SEC study and the adoption of more general policies.

Finally, if the public is today dissatisfied with the securities market, the more likely cause is not excessive regulation, but loss of investor confidence. Although Michael Lewis overstates, the public see securities markets today as dominated by high frequency traders who have privileged access to both information and trade execution. I submit that this perception, not excessive regulation, should be this Committee's primary concern.